NOBLE LAW

Restructuring Lessons Learned Alert – Lender Liability

This memorandum discusses various issues relating to lender liability that may be of interest to bankruptcy attorneys representing lenders and borrowers. Coverage includes discussion of liability for breach of contract; tort liability; statutory liabilities, such as liability under the Comprehensive Environmental Response, Compensation, and Liability Act, the Racketeer Influenced and Corrupt Organizations Act, various securities laws, the Internal Revenue Code, and the Fair Labor Standards Act; and litigation strategies.

If you have any questions or comments regarding this alert, or would like to discuss the issues raised in this alert, please contact us at Noble Law PLLC.

# Lender Liability


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# I. BREACH OF CONTRACT

## A. BREACH OF A CONTRACT TO LOAN

### § 174:1 Generally

Liability for breach of an oral or written loan agreement has been based on breach of contract, promissory estoppel, and fraud theories.[1] Liability based on breach of contract requires the formation of a contract that is sufficiently definite and complies with the statute of frauds.[2]

### § 174:2 Breach of an oral contract to loan

An enforceable oral contract can arise from the parties' statements or conduct. The contract may be enforceable even though the lender lacked actual authority to make the loan[1] unless, however, the borrower knew that the lender lacked authority.[2]

### § 174:3 Breach of an oral contract to loan—Definiteness

An enforceable oral contract to loan requires agreement between the parties as to the material terms of the loan.[1] The courts vary significantly, however, regarding the definiteness necessary to create an enforceable contract. Some courts require evidence of a specific

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[Section .1]

[1]See § .17 for a discussion of liability based on fraud.

[2]See Restatement Second, Contracts §§ 9 to 109 (1979).

[Section .2]

[1]*National Farmers Organization, Inc. v. Kinsley Bank*, 731 F.2d 1464, 1467 (10th Cir. 1984) (holding bank liable under Kansas law for oral agreement to loan over $1 million even though amount exceeded the bank's legal lending limits); *Bolus v. United Penn Bank*, 363 Pa. Super. 247, 525 A.2d 1215, 1221-1223 (1987) (holding bank liable for officer's oral commitment even though officer lacked actual authority to make a loan of that size). This rule does not apply in the context of government loan contracts. See, e.g., *Harbert / Lummus Agrifuels Projects v. U.S.*, 142 F.3d 1429, 1432, 42 Cont. Cas. Fed. (CCH) P 77284 (Fed. Cir. 1998) (noting that government is not bound by acts of agents beyond the scope of their authority and the burden is on the plaintiff to prove that government agent had the authority to enter into the oral, unilateral contract).

[2]*Clardy Mfg. Co. v. Marine Midland Business Loans Inc.*, 88 F.3d 347, 358-59 (5th Cir, 1996) (holding that borrower was unable to rely on statements by lender's senior business development officer that "everything looked good" and he "expected" a commitment letter to be issued within five days since borrower knew officer had no credit approval authority); *Runnemede Owners, Inc. v. Crest Mortg Corp.*, 861 F.2d 1053, 1059, 12 Fed, R. Serv. 3d 787 (7th Cir. 1988) (holding the borrower unable to rely on oral representations which were contrary to qualified letter of commitment); *Kruse v. Bank of America*, 202 Cal. App. 3d 38, 248 Cal. Rptr. 217, 220 (1st Dist. 1988) (holding the borrower unable to rely on loan officer's oral commitments where borrower was fully aware of the officer's limited lending authority).

[Section .3]

[1]See Restatement Second, Contracts § 33(2) (stating that a contract must "provide a basis for determining the existence of a breach and for giving an appropriate remedy") (1979).

agreement on all material terms including the amount and interest rate for the loan.[2] Similarly, an oral agreement to modify a loan may need to be sufficiently definite to be enforceable.[3] Other courts, conversely, have shown a willingness to specify certain material terms based on the lender's commercial practice and the parties' course of dealing.[4] For

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[2]See *State Bank of Standish v. Curry*, 442 Mich. 76, 88, 500 N.W.2d 104, 109-10 (1993) ("For a promise to loan money in the future to be sufficiently clear and definite, some evidence must exist of the material terms of the loan, including the amount of the loan, the interest rate, and the method of repayment."); see also, e.g., *Meima v. Broemmel*, 2005 WY 87, 117 P.3d 429 (Wyo. 2005) (oral agreement was not enforceable even though lender agreed to finance borrower's purchase, since parties had not agreed on interest rate, repayment schedule, or other material terms); *Nelson v. Production Credit Ass'n of the Midlands*, 930 F.2d 599, 605 (8th Cir. 1991) (setting aside an alleged oral agreement to make a loan where the parties "never reached any specific agreement about how much money the [credit association] would lend" and declining to determine the amount based on the parties' course of dealings and the borrowers' financial plan); *Demos v. National Bank of Greece*, 209 Ill, App. 3d 655, 153 Ill. Dec. 856, 567 N.E.2d 1083, 1087 (1st Dist. 1991) (holding that an oral loan agreement was unenforceable as a matter of law where the parties failed to agree on a specific rate of interest even if the bank had orally agreed to charge the "prevailing" rate); *DeMaine v. Bank One, Akron, N.A.*, 904 F.2d 219, 220, 16 Fed. R. Serv. 3d 1847 (4th Cir; 1990) (oral agreement was not enforceable, even though loan officer told prospective borrower to "tell the sellers you have your financing," where no agreement was reached as to the amount of the loan, the funding date, or the repayment schedule); *American Viking Contractors, Inc. v. Scribner Equipment Co., Inc.*, 745 F.2d 1365, 39 U.C.C. Rep. Serv. 1354 (11th Cir. 1984) (under Georgia law an oral restructuring agreement was too indefinite to be enforceable where the parties failed to reach an agreement regarding the interest rate or duration of the new payment period); *Champaign Nat. Bank v. Landers Seed Co., Inc.*, 165 Ill. App. 3d 1090, 116 Ill. Dec. 742, 519 N.E.2d 957, 960 (4th Dist. 1988) (oral agreement unenforceable where "[n]o cost of money terms were included in the alleged agreement; no terms exist as to additional capital advances or duration of loan; maturity dates were not provided; [and] mode or rate of repayment was not contemplated").

[3]See, e.g., *Daniels v. Select Portfolio Servicing, Inc.*, 246 Cal. App. 4th 1150, 1176, 201 Cal. Rptr, 3d 390, 414 (6th Dist. 2016) (finding oral agreement to modify loan insufficiently definite as the essential terms of the loan modification were not agreed, taking into consideration the lack of extrinsic applicable guidelines).

[4]*Kotera v. Daioh Intern, U.S.A. Corp.*, 179 Or. App. 253, 40 P.3d 506, R.I.C.O. Bus. Disp. Guide (CCH) P 10220 (2002) (evidence was sufficient to establish existence of creditor's loan to debtor; interest rate and date of principal repayment were established by creditor's testimony); *Philips Credit Corp. v. Regent Health Group, Inc.*, 953 F. Supp. 482, 513-514 (S.D. N.Y. 1997) (applying New York law); *Landes Const. Co., Inc. v. Royal Bank of Canada*, 833 F.2d 1365, 1368, 24 Fed. R. Evid. Serv. 885 (9th Cir. 1987) (applying California law and upholding jury verdict that the bank orally agreed to loan the borrowers $10 million to finance the purchase of commercial real estate based on the borrowers' testimony that the parties agreed to a $10 million loan and an interest rate of "prime plus two").

example, In *National Farmers Organization, Inc. v. Kinsley Bank*,[5] the Tenth Circuit upheld a jury finding that the parties' oral loan agreement was sufficiently definite where the "approximate amount" and the "approximate time of the loan" were set and "the rate of interest and the terms of repayment could be determined by reference to commercial practice and the customary course of business between the bank and [the borrower]." Similarly, in *Coastland Corp. v. Third Nat. Mortg. Co.*,[6] the Fourth Circuit indicated that a contract is "sufficient[ly] definite if there is certainty as to the general scope and stipulation of the contract." The court then upheld the district court's finding that the bank orally agreed to loan $2.2 million for up to 18 months with an interest rate of 4.5% over prime and a commitment fee of between $20,000 and $40,000.

Although formation of an oral contract is conceptually separate from enforcement of a contract, they overlap when the indefiniteness is due to a lack of mutual assent.[7] Litigation regarding definiteness, consequently, will often focus on the parties' intent as evidenced by their course of dealing in documenting their loan agreements and their credibility regarding the content of the negotiations.

### § 174:4 Breach of an oral contract to loan—Statute of frauds

An enforceable oral contract must also comply with the statute of frauds.[1] A majority of states have enacted legislation barring the enforcement of oral loan commitments. These statutes, however, vary significantly by state and so the applicable state's statutes and case law must be reviewed to determine the enforceability of any oral financial

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[5] *National Farmers Organization, Inc. v. Kinsley Bank*, 731 F.2d 1464, 1470 (10th Cir. 1984) (applying Kansas law). Cf. *First Nat. Bank of Logansport v. Logan Mfg. Co., Inc.*, 577 N.E.2d 949, 953, 18 A.L.R.5th 999 (Ind. 1991) (noting that oral promise to lend money must be sufficiently definite as to the essential elements, and finding that on the facts of the case, missing terms could not be supplied because there was no history of business dealings between the parties).

[6] *Coastland Corp. v. Third Nat. Mortg. Co.*, 611 F.2d 969, 976 (4th Cir. 1979) (internal citation omitted). See also *Wait v. First Midwest Bank / Danville*, 142 Ill. App. 3d 703, 96 Ill. Dec. 516, 491 N.E.2d 795 (4th Dist. 1986) (same).

[7] See, generally, Williston on Contracts § 1:3 (4th ed.); Farnsworth, Contracts §§ 3.1, 3.27 (1982).

[Section .4]

[1] The statute of frauds may not preclude a lender liability action based on a tort or other noncontract theory arising out of the alleged oral agreement. See *Brown v. Founders Bank and Trust Co.*, 1994 OK 130, 890 P.2d 855 (Okla. 1994) (holding that statute of frauds did not bar cause of action against lender for fraud); *Frame v. Boatmen's Bank of Concord Village*, 782 S.W.2d 117 (Mo. Ct. App. E.D. 1989) (holding that failure to comply with statute of frauds did not bar claim based on negligent misrepresentation).

commitment.[2] Note that certain oral contracts may, however, fall outside of the statute of frauds. For instance, the traditional statute of frauds requires that a contract for the sale of an interest in land, including a contract to grant a mortgage in real estate.[3] However, in *Landes Const. Co., Inc. v. Royal Bank of Canada*,[4] the Ninth Circuit held that an oral agreement to grant a mortgage lien in real estate was separate from the oral agreement to loan the money to purchase the real estate. Consequently, the oral agreement to loan was not barred by the statute of frauds.

## § 174:5 Breach of a written contract to loan

An enforceable written contract to loan can arise based on the provisions contained in a letter or other written document,[1] as long as it

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[2]See Culhane, Jr. & Gramlich, Lender Liability Limitation Amendments to State Statutes of Frauds, 45 Business Law 1779 (1990) (reviewing the various state enactments, discussing seven issues that must be explored to ascertain the effect of a particular state statute on a specific lender liability claim, and proposing a model statutes); Darren A. Craig and Heidi G. Goebel "WRITE WHEN? Statutes of Frauds Applicable to Credit Agreements," 50 No. 10 DRI For Def. 16 (examining the differences and similarities among the statutes of frauds applicable to credit agreements, the important textual differences among the various statutes and the differing interpretations offered by various courts, and including tabular summary of the various statutes of frauds for reference to practitioners). See also *Cohn v. Bank of America*, 2011 WL 98840, *11 (E.D. Cal. 2011) ("District courts have increasingly concluded that a plaintiff may not state a claim for breach of an oral contract for the provision of a loan modification because such an oral contract would violate the statute of frauds.").

[3]Restatement Second, Contracts §§ 110 to 150 (1979).

[4]*Landes Const. Co., Inc. v. Royal Bank of Canada*, 833 F.2d 1365, 1370, 24 Fed. R. Evid. Serv. 885 (9th Cir. 1987); but see *Frame v. Boatmen's Bank of Concord Village*, 782 S.W.2d 117, 119-120 (Mo. Ct. App. E.D. 1989) (holding that "parties' oral agreement was unenforceable since it was clear the parties intended that [borrower] execute a mortgage on the [real] property as security for the loan" and this was a necessary element to find the terms of the oral agreement sufficiently definite to be enforceable).

[Section .5]

[1]See *Consarc Corp. v. Marine Midland Bank, N.A.*, 996 F.2d 568, 572-73 (2d Cir. 1993) (holding that issues of material fact as to whether exchange of letters between bank and manufacturer formed written contract precluded summary judgment for bank); *Greenberg v. Broad Capital Associates, Inc.*, 2002 WL 31269617, *1 (N.D. Ill. 2002) (finding a written contract based on: "(i) a January 23, 1995 letter, [the defendant] wrote to BCA, confirming the terms of the loan; and (ii) a Shtar Iska, a Jewish religious explanation of interest and profit, which [the plaintiff] signed"); *Sterling Faucet Co. v. First Mun. Leasing Corp.*, 716 F.2d 543 (8th Cir. 1983) (mem.) (holding that a letter that the lender characterized as "a mere invitation to negotiate a contract" was a binding contract because the letter set forth the parties, the amount and terms of the loan, and the conditions precedent to funding the loan).

is sufficiently definite[2] and otherwise constitutes a contract.[3] For instance, courts frequently will focus on whether conditions precedent, as set forth in the writings purporting to form a contract, were satisfied.[4]

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[2]See *Willowood Condominium Ass'n Inc. v. HNC Realty Co.*, 531 F.2d 1249, 1251-52 (5th Cir. 1976) (holding that two letters, when construed together, did not create a binding commitment, although the second letter stated "your loan on the above captioned property was approved," because the letters were ambiguous regarding the interest rate and the closing, disbursement, and repayment dates); see also *University Creek Associates, II, Ltd. v. Boston American Financial Group, Inc.*, 100 F. Supp. 2d 1337 (S.D. Fla. 1998) (holding that loan commitment letter which failed to specify amount of interest, terms of repayment, or funding was not contract enforceable in action for breach).

[3]See *Cohen v. Lehman Brothers Bank, FSB*, 273 F. Supp. 2d 524 (S.D. N.Y. 2003) (holding that prospective borrower's loan application did not constitute enforceable agreement, where application stated clearly and unequivocally that it was not commitment to lend); see also *Freeman Horn, Inc. v. Trustmark Nat. Bank*, 245 B.R. 820, 827 (S.D. Miss. 1999) (finding no agreement where there had been no acceptance of an offer to lend).

[4]See, e.g., *A / S Apothekernes Laboratorium for Specialpraeparater v. I.M.C. Chemical Group, Inc.*, 873 F.2d 155, 157 (7th Cir. 1989) (holding that although parties reached a meeting of the minds on all substantial points, there was no binding agreement since letter of intent stated that it was "subject to our concluding an Agreement of Sale which shall be acceptable to the Board of Directors"); *Runnemede Owners, Inc. v. Crest Mortg. Corp.*, 861 F.2d 1053, 1054, 12 Fed. R. Serv. 3d 787 (7th Cir. 1988) (holding that letter labeled "a 'commitment' letter . . . did not in fact commit to extend the proposed loan; instead [the lender] agreed to make the loan subject to a number of conditions"); *In re Nantahala Village, Inc.*, 976 F.2d 876, 881, 23 Bankr. Ct. Dec. (CRR) 1025, Bankr. L. Rep. (CCH) P 74944; 18 U.C.C. Rep. Serv. 2d 1027 (4th Cir. 1992) (holding that bank was not liable for breach of contract because the borrower failed to comply with the preconditions to the bank's agreement to renegotiate); *Transit Management, LLC v. Watson Industries, Inc.*, 23 A.D.3d 1152, 803 N.Y.S.2d 860 (4th Dep't 2005) (holding that lender's obligation under commitment letter never arose because debtor failed to satisfy condition precedent, namely, that borrower provide written confirmation of firm payoff figures for its state and federal tax liabilities); *Prestige Foods, Inc. v. Whale Securities Co., L.P.*, 243 A.D.2d 281, 663 N.Y.S.2d 14 (1st Dep't 1997) (dismissing breach of contract claim because letter agreements "expressly stated that neither party had any legal obligations to [the] other until both had executed and delivered an underwriting agreement"); *Becker v. HSA / Wexford Bancgroup, L.L.C.*, 157 F. Supp, 2d 1243 (D, Utah 2001) ("Courts have usually treated the terms and conditions of a loan commitment as conditions precedent to the lender's obligation to perform. . . [The bank's] commitment to make the loan . . . as reflected in its Commitment Letter must thus be read in light of its own express conditions, strictly enforced. . .").

Failure to satisfy these conditions prior to the expiration date contained in the writing may preclude enforcement of the commitment.[5]

In determining whether the documents created an enforceable contract, the courts will focus on the parties' intent as indicated by the circumstances surrounding the negotiation and as manifested in the documents.[6] However, if the writings contain an integration clause, the parole evidence rule may preclude evidence of prior written, and prior

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[5]See *Northwest Hamilton Lake Development Co., L.L.C. v. American Federal, Inc.*, 2006 WL 381499 (E.D. Mo. 2006) (holding that conditional commitment never became binding contract where there was no evidence that borrower fulfilled all of the conditions set forth in the conditional commitment and where lender never issued closing instrument); *Health & Community Living, Inc. v. Goldis Financial Group, Inc.*, 1998 WL 117928 (E.D. N.Y. 1998) (holding that lender was not liable for breach of contract because the borrower failed to satisfy the multiple conditions set forth in letter); *Towers Charter & Marine Corp. v. Cadillac Ins. Co.*, 894 F.2d 516, 521 (2d Cir. 1990) (holding that lender did not breach loan commitment where borrower failed to provide an appraisal prior to expiration date); *Penthouse Intern., Ltd. v. Dominion Federal Sav. & Loan Ass'n*, 855 F.2d 963, 983 (2d Cir. 1988) (holding that borrower failed to establish that it was ready, willing, and able to perform its contractual obligations by the expiration date); cf. *Hidalgo Properties, Inc. v. Wachovia, Mortg. Co.*, 617 F.2d 196, 199 (10th Cir. 1980) (holding that issue of fact existed as to whether lender waived conditions precedent and was therefore required to make a loan).

[6]See *Soffer v. Bank of Nova Scotia*, 2014 WL 2938454, *2 (Nev. 2014) ("It is well settled that a contract is to be construed in accordance with the parties' intent, which is generally discerned from the four corners of the document itself," *MHR Capital Partners LP v. Presstek, Inc.*, 12 N.Y.3d 640, 884 N.Y.S.2d 211, 912 N.E.2d 43, 47 (2009). A "fundamental tenet of contract law [is] that enforceable legal rights do not arise from contract negotiations until both parties consent to be bound or, in any event, manifest that consent to each other," *Chrysler Capital Corp. v. Southeast Hotel Properties Ltd. Partnership*, 697 F. Supp. 794, 799 (S.D. N.Y. 1988), judgment aff'd, 888 F.2d 1376 (2d Cir. 1989) (applying New York law). " '[W]hen a party gives forthright, reasonable signals that it means to be bound only by a written agreement,' that intent is honored." *Kowalchuk v. Stroup*, 61 A.D.3d 118, 873 N.Y.S.2d 43, 47 (1st Dep't 2009) (quoting *Jordan Panel Systems, Corp. v. Turner Const. Co.*, 45 A.D.3d 165, 841 N.Y.S.2d 561, 565 (1st Dep't 2007)); see also *A / S Apothekernes Laboratorium for Specialpraeparater v. Chemical Group, Inc.*, 873 F.2d 155, 157-158 (7th Cir. 1989) ("Under Illinois law, courts focus on the parties' intentions to determine whether an enforceable contract comes into being during the course of negotiations, or whether some type of formalization of the agreement is required before it becomes binding."); *Teachers Ins. and Annuity Ass'n of America v. Tribune Co.*, 670 F. Supp. 491, 497 (S.D. N.Y. 1987) (holding that commitment letter constituted an enforceable contract and stating that "prime significance attaches to the intentions of the parties and to their manifestations of intent").

or contemporaneous oral, agreements to limit or contradict the terms of the writing.[7]

### § 174:6 Liability based on promissory estoppel

An agreement to make a loan that is not enforceable as a contract may still be enforceable based on promissory estoppel. The requirements to establish liability based on promissory estoppel are set forth in the Restatement (Second) of. Contracts, Section 90(1), which provides:

> A promise which the promisor should reasonably expect to induce action or forbearance on the part of the promisee or a third person and which does induce such action or forbearance is binding if injustice can be avoided only be enforcement of the promise. The remedy granted for breach may be as limited as justice requires.

Promissory estoppel has been used to impose liability on a bank for failure to make a loan where the promise was too indefinite for

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[7]Restatement Second, Contracts § 213 (1979); cf. *Federal Deposit Ins. Corp. v. W.R. Grace & Co.*, 877 F.2d 614, 620 (7th Cir. 1989) ("parole and other extrinsic evidence is, admissible, even in a case involving a contract with an integration clause, to demonstrate that the contract is ambiguous").

enforcement as a contract,[1] contained a condition that was not satisfied,[2] or was unenforceable under the statute of frauds.[3]

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[Section .6]

[1] *Whorley v. First Westside Bank*, 240 Neb. 975, 485 N.W.2d 578, 582 (1992) ("[T]here is no requirement of 'definiteness' in an action based upon promissory estoppel, only that the reliance be reasonable and foreseeable") (noting disagreement and collecting cases); but see *Woodwinds, Inc. v. Dimeo*, 229 F.3d 1136 (2d Cir. 2000) (holding that promissory estoppel claim was properly dismissed for lack of a clear and definite promise regarding long-term financing); *Central Production Credit Ass'n v. Reed*, 805 S.W.2d 300, 302 (Mo. Ct. App. S.D. 1991) ("indefiniteness prevents any valid agreement either in contract or estoppel"); *Demos v. National Bank of Greece*, 209 Ill. App. 3d 655, 153 Ill. Dec. 856, 567 N.E.2d 1083, 1087-1088 (1st Dist. 1991) (stating that promissory estoppel was inappropriate where the agreement was too indefinite to be enforced as an oral contract); *Mellon Bank, N.A. v. Miglin*, 1993 WL 281111, *6 (N.D. Ill. 1993) ("However, to invoke promissory estoppel, counterplaintiffs must show, at a minimum, the existence of an enforceable promise on which they reasonably relied."); *Peterson Development Co. v. Torrey Pines Bank*, 233 Cal. App. 3d 103, 284 Cal. Rptr. 367, 374 (4th Dist. 1991) (holding that commitment, which did not contain all the material terms, would not support liability based on breach of contract or promissory estoppel).

[2] See, e.g., *Budget Marketing, Inc. v. Centronics Corp.*, 927 F.2d 421, 426-427 (8th Cir. 1991) (holding that a letter of intent was not binding and did not give rise to an implied duty to negotiate in good faith but also that a triable issue existed as to the borrower's promissory estoppel claim since the borrower allegedly spent substantial sums to comply with the conditions stated in the letter of intent based on the bank's oral assurances such that it was ready to "mov[e] ahead toward a closing."); see also *Merrill Lynch Private Capital, Inc. v. Abou Khadra*, 764 F.Supp. 921, 924 (S.D. N.Y. 1991) (holding that complaint stated a cause of action based on promissory estoppel where bank initially promised to provide the loan without a guarantee and borrowers, in reliance on that promise, changed their positions to their detriment).

[3] *United of Omaha Life Ins. Co. v. Nob Hill Associates*, 450 So. 2d 536, 539 (Fla. 3d DCA 1984); *Fortress Systems, L.L.C. v. Bank of West*, 559 F.3d 848, 854 (8th Cir. 2009) ("Since Edwards's alleged oral promise of December 10 involved a credit agreement, it came within the ambit of [the Nebraska statement of frauds]. There is no written agreement signed by both parties memorializing such promise, and Fortress's claim must fail as a matter of law whether pled as breach of contract or promissory estoppel.); *Mark Andrew of Palm Beaches, Ltd. v. GMAC Commercial Mortg. Corp.*, 265 F. Supp. 2d 366 (S.D. N.Y. 2003), judgment aff'd, 96 Fed. Appx, 750 (2d Cir. 2004) (holding under Florida law that borrowers' promissory estoppel claim against lender that allegedly failed to comply with loan contract was barred by statute of frauds, where borrowers' claim was based on the existence of an allegedly oral contract).

Unlike a claim based on breach of contract, however, a claim based on promissory estoppel may not support a right to a trial by jury.[4] Further, damages may be limited to reliance.[5]

## B. WRONGFUL DETERMINATION OF DEFAULT

### § 174:7 Generally

A lender may exercise its default remedies or refuse to perform if the borrower fails to comply with the provisions contained in the loan agreement. A lender may, however, be liable for its exercise or refusal if a court determines that the borrower was not in default under the original loan agreement due to waiver or substantial performance or due to a modification of the original agreement.

### § 174:8 Determining the standard of performance

A lender may be discharged from performance based on a borrower's failure to satisfy a condition of the loan agreement,[1] or may be entitled to damages (but be required to perform the loan).[2] A condition requires strict performance while an independent promise requires substantial performance.[3] A condition, as defined by the Restatement, is "an event, not certain to occur, which must occur, unless its non-occurrence is

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[4] *In re Dakota Rail, Inc.*, 1990 WL 92437 (Bankr. D. Minn. 1990) (citing *C & K Engineering Contractors v. Amber Steel Co.*, 23 Cal. 3d 1, 10, 151 Cal. Rptr. 323, 328, 587 P.2d 1136, 1141 (1978)).

[5] *Budget Marketing, Inc. v. Centronics Corp.*, 927 F.2d 421, 428 (8th Cir. 1991) ("Damages under promissory estoppel are often limited by the extent of the promisee's reliance rather than by the terms of the promise.") (citing *Arcadian Phosphates, Inc. v. Arcadian Corp.*, 884 F.2d 69 (2d Cir. 1989)).

[Section .8]

[1] See, e.g., *Hope Furnace Associates, Inc. v. F.D.I.C.*, 71 F.3d 39, 43 (1st Cir. 1995) (holding that plaintiffs failure to fulfill wetlands conditions of loan agreement discharged lender from duty to perform); *Eaglehead Corp. v. Cambridge Capital Group, Inc.*, 170 F. Supp. 2d 552, 557-58 (D. Md. 2001) (holding loan commitment clearly conditioned funding of loan on lender's approval of current appraisal of collateral). But see *Varel v. Banc One Capital Partners, Inc.*, 55 F.3d 1016 (5th Cir. 1995) (reversing lower court's finding that borrower's failure to perform condition excused lender's performance, explaining that Texas disfavors forfeiture and failure to perform was excusable).

[2] See *46933, Inc. v. Z & B Enterprises, Inc.*, 899 S.W.2d 800, 807 (Tex. App. Amarillo 1995), writ denied, (Nov. 2, 1995) ("In order for a breach to constitute a bar to the other party's right to recover, it must be a breach of a mutually dependent covenant.").

[3] *Brown-Marx, Associates, Ltd. v. Emigrant Sav. Bank*, 703 F.2d 1361, 1367, 36 Fed. R. Serv. 2d 895 (11th Cir. 1983) (holding that it was insufficient for borrower to have substantially complied with minimum lease requirement in mortgage loan commitment; strict compliance was required for condition).

excused, before performance under a contract becomes due."[4] Loan provisions tend to be interpreted by the courts not as conditions but as independent promises, though this determination is fact-specific and ultimately depends on the parties' intent.[5]

## § 174:9 Determining the standard of performance—Excuse of a condition through waiver

The rule of strict performance applicable to a condition may be vitiated by the doctrine of waiver.[1] Accordingly, a lender may be precluded from enforcing its default remedies based on the breach of a loan condition if the condition was waived.[2] Waiver results from acts or a failure to act which is inconsistent with an intent to enforce the

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[4]Restatement Second, Contracts § 224 (1981). See also *U.S. v. Podolsky*, 798 F.2d 177, 178 (7th Cir. 1986) ("Conditions, express or implied, do not make a contract unenforceable; they merely define the circumstances in which a party can avoid having to perform his contractual obligation; they presuppose rather than nullify the obligation.").

[5]*Sahadi v. Continental Illinois Nat. Bank and Trust Co. of Chicago*, 706 F.2d 193, 198-99 (7th Cir. 1983) (stating that, generally, contract terms are presumed to represent independent promises rather than conditions and explaining that "[d]etermining whether this presumption [terms represent independent promises] may be upset entails a full inquiry into the 'intention of the parties and the good sense of the case' including such factors as whether the protected party can achieve its principal goal without literal performance of the contractual provision,") (internal citations omitted).

[Section .9]

[1]See *Hidalgo Properties, Inc. v. Wachovia Mortg. Co.*, 617 F.2d 196, 199 (10th Cir. 1980) (holding that failure of lender to demand performance when it knew time for performance had come and gone created issue of waiver for jury); see also Farnsworth, Contracts § 8.5, at 662 (1982) ("By characterizing the conduct as a 'waiver' rather than as a 'modification,' the court may avoid three requirements for a modification: the requirement of assent, the requirement of a writing under the statute of frauds, and the requirement of consideration or of detrimental reliance.").

[2]See *National Westminster Bank, U.S.A. v. Ross*, 130 B.R. 656, 675, 16 U.C.C. Rep. Serv. 2d 272 (S.D. N.Y, 1991), aff'd, 962 F.2d 1 (2d Cir. 1992) (holding that borrower waived bank's breach of loan agreement by continuing to accept advances under the loan agreement); cf *In re Kids Creek Partners, L.P.*, 212 B.R. 898 (Bankr. N.D. Ill. 1997), decision aff'd, 233 B.R. 409 (N.D. Ill. 1999), aff'd, 200 F.3d 1070, 35 Bankr. Ct. Dec. (CRR) 123 (7th Cir. 2000) and decision aff'd, 239 B.R. 497 (N.D. Ill. 1999) (holding that lender did not waive any defaults by continuing to advance funds pursuant to loan agreements, as mere continued advancement of money did not show intent to waive its rights).

condition.[3] In *First Bank Southeast, N.A. v. Predco, Inc.*,[4] however, the Seventh Circuit held that a lender's failure to exercise its right under a guarantee for a period of several years was not inconsistent with its right of enforcement and did not result in waiver of that right since "utilization of the [guarantee] was not conditioned upon any obligation to notify [the guarantor] that the bank intended to enforce the agreement."

The doctrine of waiver may apply to excuse the breach of a condition in the loan agreement that is "procedural or technical, or to instances in which the non-occurrence of condition is comparatively minor."[5] In *Champaign Nat. Bank v. Landers Seed Co., Inc.*,[6] however, the court held that "[t]he right to collect a debt when due is not a procedural or technical right" that can be waived. Consequently, the lender did not waive its right to call a promissory note approximately six months after it was due based on an alleged forbearance agreement that was too indefinite to be enforced.[7]

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[3]Farnsworth, Contracts, § 8.5 (1982); *Mitchell v. Pacific First Bank*, 130 Or. App. 65, 880 P.2d 490 (1994) (lender waived performance through consistent practice of accepting late payments); *Formall, Inc. v. Community Nat. Bank of Pontiac*, 166 Mich. App. 772, 421 N.W.2d 289 (1988) (holding that a material issue of fact existed as to whether the lender waived its right to declare the borrower's loans in default and exercise its legal remedies where the lender continued to accept interest payments after the borrower's primary loan came due). Cf. *CoBank, ACB v. Reorganized Farmers Cooperative Ass'n*, 334 F. Supp. 2d 1273 (D. Kan. 2004), aff'd, 170 Fed. Appx. 669 (10th Cir. 2006) (holding that bank did not waive default by advancing additional sums after notifying borrower that it was in default for failing to meet working capital requirements).

[4]*First Bank Southeast, N.A. v. Predco, Inc.*, 951 F.2d 842 (7th Cir. 1992).

[5]Restatement Second, Contracts § 84, comment d (1979). See also *Ringold v. Bank of America Home Loans*, 2013 WL 1450929, *4 (W.D. Tenn. 2013) ("The doctrine of waiver "applies primarily to conditions which may be thought of as procedural or technical.").

[6]*Champaign Nat. Bank v. Landers Seed Co. Inc.*, 165 Ill. App. 3d 1090, 1097, 116 Ill. Dec. 742, 519 N.E.2d 957, 962 (4th Dist. 1988).

[7]See also *Fleet Bank of Maine v. Matthews*, 795 F. Supp. 492, 498 n.5 (D. Me. 1992) (stating that borrower's claim that bank, as assignee of FDIC, waived right to foreclose by its conduct in accepting late payment was barred by the *D'Oench* doctrine (a banking rule that prevents a borrower or guarantor from entering into an agreement with an insolvent or failed bank when a federal government insurer is attempting to collect on a loan)).

A lender may not waive a right, however, unless it has knowledge of all the material facts upon which the lender's right depends.[8] For example, in *Brown-Marx Associates, Ltd. v. Emigrant Sav. Bank*,[9] the Eleventh Circuit held that the lender had not waived a minimum rental provision in a loan agreement by telling the borrower that a rent roll it submitted was "satisfactory" since the lender could not have known of the document's defects from its face.

A court may refuse to apply waiver where the loan documents contain an anti-waiver provision.[10] In *Minor v. Chase Auto Finance Corp.*,[11] the court explained that a lender's acceptance of late payments did not constitute a waiver of the lender's right to enforce its default remedies based on the existence of a no-waiver clause in the contract.

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[8]See *AeroGlobal Capital Management, LLC v. Cirrus Industries, Inc.*, 871 A.2d 428, 444 (Del. 2005) (stating that waiver "implies knowledge of all material facts and an intent to waive, together with a willingness to refrain from enforcing those contractual rights"); *Soter's, Inc. v. Deseret Federal Sav. & Loan Ass'n*, 857 P.2d 935, 942 (Utah 1993) (stating that to constitute waiver, "there must be an existing right, benefit or advantage, a knowledge of its existence, and an intention to relinquish it").

[9]*Brown-Marx Associates, Ltd. v. Emigrant Sav. Bank*, 703 F.2d 1361, 36 Fed. R. Serv. 2d 895 (11th Cir. 1983).

[10]See *Monarch Coaches, Inc. v. ITT Indus. Credit*, 818 F.2d 11, 3 U.C.C. Rep. Serv. 2d 1274 (7th Cir. 1987) ("By assuring that a lender will not be penalized for his forbearance, a no-waiver clause is . . . in the interest of debtors as well as creditors, for it makes the creditor likelier to accept late payments rather than declaring a default. There is no possible injustice in enforcing the clause against [the borrower]"); see also *Flushing Unique Homes, LLC v. Brooklyn Federal Sav. Bank*, 100 A.D.3d 956, 954 N.Y.S.2d 606 (2d Dep't 2012) (holding no waiver based either on lender's delay in enforcing the terms of the promissory note evidencing a building loan or its issuance of the consequent monthly statements after the maturity date, where the note contained a no waiver clause that provided that neither the exercise of any provision nor the delay in asserting any right should be construed as waiver by lender of the right to accelerate the indebtedness); *Republic Bank v. Britton Estates, L.L.C.*, 2006 WL 445916 (Mich. Ct. App. 2006) (affirming summary judgment for lender in foreclosure action despite borrower's allegations that lender agreed to modify or waive right to full performance since there was no evidence of written waiver as was required by loan documents); *B.P.G. Autoland Jeep-Eagle, Inc. v. Chrysler Credit Corp.*, 799 F. Supp. 1250, 1256, 19 U.C.C. Rep. Serv. 2d 649 (D. Mass. 1992) (holding that, under Connecticut law, the nonwaiver clause precluded waiver of the lender's right to abruptly refuse to continue the floor-plan financing). Cf. *Westinghouse Credit Corp. v. Skelton*, 645 F.2d 869, 31 U.C.C. Rep. Serv. 410 (10th Cir. 1981) (stating that anti-waiver clause in security agreement is subject to waiver or modification by course of performance); *Quality Products and Concepts Co. v. Nagel Precision, Inc.*, 469 Mich. 362, 666 N.W.2d 251 (2003) (stating that parties are free to mutually waive or modify their contract, notwithstanding a written modification or anti-waiver clause).

[11]*Minor v. Chase Auto Finance Corp.*, 2010 Ark. 246, 372 S.W.3d 762, 766-67, 72 U.C.C. Rep. Serv. 2d 610 (2010).

Examining the split in authorities on this topic, the court explained its agreement with courts interpreting such provisions strictly:

> A rule providing that nonwaiver clauses could themselves be waived by the acceptance of late payments is illogical, since the very conduct which the non-waiver clause is designed to permit, acceptance of late payment is turned around to constitute waiver of the clause permitting the conduct. We also agree that the approach of jurisdictions that require creditors who have accepted late payments in the past to notify debtors that they expect strict compliance in the future, despite the existence of a nonwaiver provision in the contract, is not "sound." Such a rule, we recognize, "begs the question of validity of the non-waiver clause." Finally, [we will] enforce the provisions of the contract, since the parties had agreed to them, and that [will] not require the creditor to give notice, because the nonwaiver clause place[s] the secured party in the same position as one who had never accepted a late payment.[12]

Conversely, in *Westinghouse Credit Corp. v. Shelton*,[13] the Tenth Circuit stated that "an 'anti-waiver' clause, like any other term in the contract, is itself subject to waiver or modification by course of performance and that whether such waiver or modification has occurred is a question for the fact finder." The court then reversed the grant of summary judgment and remanded the case to the trial court for a determination of whether the lender waived its right to strictly enforce the loan agreement's terms by accepting the borrower's late payments.

To avoid liability based on enforcement of a provision that has been waived by the parties' course of dealing, particularly where the loan documents do not contain a no-waiver clause, a lender should retract the waiver and reinstate the condition by making a demand for performance and giving the borrower reasonable notice that the lender will begin to insist on strict compliance with the loan provision.[14]

### § 174:10 Determining the standard of performance—Completion of promise by substantial performance

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[12]In *Minor v. Chase Auto Finance Corp.*, 2010 Ark. 246, 372 S.W.3d 762, 766-67, 72 U.C.C. Rep. Serv. 2d 610 (2010) (internal citations omitted).

[13]*Westinghouse Credit Corp. v. Shelton*, 645 F.2d 869, 31 U.C.C. Rep. Serv. 410 (10th Cir. 1981).

[14]See *Foundation Property Investments, LLC v. CTP, LLC*, 286 Kan. 597, 612, 186 P.3d 766, 776 (2008) (noting recourse available to lender after waiver of condition following notice to borrower); see also Farnsworth, Contracts § 8.5 (1982).

The rule of substantial performance applicable to an independent promise may preclude the lender from exercising its default remedies or refusing to perform based on the borrower's nonconforming performance.[1] The borrower bears the burden of showing substantial performance with all material terms,[2] so an immaterial breach by the borrower will not preclude a finding of substantial performance.[3] In *Sahadi v. Continental Illinois Nat. Bank and Trust Co. of Chicago*,[4] the Seventh Circuit stated that the determination of whether the breach of a loan provision is material is similar to the determination of whether the provision is a condition: "both seek to determine whether its performance was a sine qua non of the contracts fulfillment."[5] The court

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[Section .10]

[1]Restatement Second, Contracts § 237, comment d (1981); *First Nat. State Bank of New Jersey v. Commonwealth Federal Sav. and Loan Ass'n of Norristown, Pa.*, 456 F. Supp. 464 (D.N.J. 1978), judgment aff'd, 610 F.2d 164 (3d Cir. 1979) (holding that lender could not avoid its obligations under commitment where borrower had substantially completed construction of site); *Armstrong v. Steppes Apartments, Ltd.*, 67 S.W.3d 37 (Tex. App. Fort Worth 2001) (finding that borrower substantially performed its obligations under notes and lender was not entitled to accelerate). Cf. *Brown-Marx Associates, Ltd. v. Emigrant Sav. Bank*, 703 F.2d 1361, 36 Fed. R. Serv. 2d 895 (11th Cir. 1983) (holding that doctrine of substantial performance did not apply to minimum required rental provision of loan commitment where rental requirement was stated as a condition); *Analytical Design & Const. Group, Inc. v. Murray*, 690 P.2d 269 (Colo. App. 1984) (stating that doctrine of substantial performance is not applicable to unilateral loan commitment); *Reagan v. Bankers Trust Co.*, 863 F. Supp. 1511, 1513 (D. Utah 1994) (stating that doctrine of substantial performance by the borrower is not applicable in the case of a condition precedent to making the loan).

[2]*Israel v. National Canada Corp.*, 276 Ill. App. 3d 454, 213 Ill. Dec. 163, 668 N.E.2d 1184 (1st Dist. 1996) ("Under contract law, the party seeking to enforce the contract has the burden of proving that he has substantially complied with all material terms of the contract.").

[3]Restatement Second, Contracts § 241 (1981) (circumstances significant in determining whether failure is material); *Israel v. National Canada Corp.*, 276 Ill. App. 3d 454, 213 Ill. Dec. 163, 658 N.E.2d 1184 (1st Dist. 1995) (holding that lender's delays in funding construction loan did not constitute material breach; however, any material adverse change in borrower's financial condition constituted material breach of construction loan agreement).

[4]*Sahadi v. Continental Illinois Nat. Bank and Trust Co. of Chicago*, 706 F.2d 193, 197 (7th Cir. 1983) (emphasis removed).

[5]*Sahadi v. Continental Illinois Nat. Bank and Trust Co. of Chicago*, 706 F.2d 193, 198 (7th Cir. 1983). See also *Bear, Stearns Funding, Inc. v. Interface Group-Nevada, Inc.*, 361 F. Supp. 2d 283 (S.D. N.Y. 2005) (stating that for breach of contract to be material, it must go to root of agreement between parties); *Bank of Chicago v. Park Nat. Bank*, 266 Ill. App. 3d 890, 203 Ill. Dec. 915, 640 N.E.2d 1288 (1st Dist. 1994) (holding that lead lender's unilateral release without participant's Consent of personal guaranty given by debtor's, principal shareholder in shareholder's bankruptcy case was not material breach of participation agreement, where participant failed to establish any damages, from breach).

then held that an issue of fact existed as to whether the tender of an interest payment one day late constituted a material breach of the loan and whether the lender was consequently liable for calling the loan based on this late tender. The court noted that, while the payment date was unambiguous under the loan agreement, the lender previously accepted late payments and failed to provide any notice of its intent to insist on strict performance of the agreement, Consequently, the actual due date may not have been "of the essence," thereby precluding acceleration based on the late payment.

Similarly, in *West Development Group, Ltd. v. Horizon Financial, F.A.*,[6] the court held that the borrower's obligation to deliver a junior mortgage and note to the lender for its approval prior to funding the note was not a condition but was part of the borrower's promised performance and that the borrower's prior submission of the documents without the inclusion of guarantees contained in the final version was not a material breach, Consequently, because the borrower substantially performed its obligations, the lender was liable for breach of contract in refusing to fund the loan. Determining the terms of the agreement

### § 174:11 Determining the terms of the agreement

A lender may be liable for exercising it; default remedies where the borrower was in compliance with the loan agreement as modified orally or by the parties' conduct.[1] Modification of a contract, unlike the waiver of a condition, requires all of the elements necessary to form a contract, including mutual assent, sufficient definiteness, and compliance with the statute of frauds.[2] The modification must also be supported by

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[6] *West Development Group, Ltd. v. Horizon Financial, F.A.*, 405 Pa. Super. 190, 592 A.2d 72 (1991).

[Section .11]

[1] Cf. *Spectra Plastics, Inc. v. Nashoba Bank*, 15 S.W.3d 832 (Tenn. Ct. App. 1999) (holding that lender did not waive right to demand payment on note without first providing notice through course of conduct, where note provided that it was not subject to oral modification).

[2] See *Wagner Enterprises, Inc. v. John Deere Shared Services, Inc.*, 397 F. Supp. 2d 1097 (N.D. Iowa 2005) (stating that a written contract may be modified by subsequent oral agreement which has essential elements of a binding contract); *In re Bunting Bearings*, 331 B.R. 313 (Bankr. N.D. Ohio 2005) (stating that oral modification is binding even against prior written contract as long as it otherwise meets essential elements of binding contract).

consideration.[3] In *Betterton v. First Interstate Bank of Arizona, N.A.*,[4] for example, the lender allegedly told the borrower that it would forgo repossession of the borrower's collateral if he would have the collateral repaired and agree to have his loan payments sent directly to the bank. When the lender repossessed the collateral the next day after the borrower retrieved it from the repair shop, the borrower sued for breach of the modified contract. In rejecting the borrower's complaint, the court stated that "consideration cannot be something which a party is already bound to do" and held that the bank's oral promise was not supported by consideration since the borrower was already bound to keep the truck in good order. On appeal, the Eighth Circuit agreed that promising to repair the truck did not constitute sufficient consideration for an oral modification, but found sufficient consideration to support the bank's promise to not foreclose by the fact that the borrower was under no preexisting duty to have funds deducted from his paycheck and paid directly to the bank on his behalf, which the borrower did.[5]

Further, an oral modification of a written loan contract may be permissible even where the loan documents contain a no-oral-

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[3]See *Aguilera v. Freedman, Anselmo, Lindberg & Rappe, LLC*, 2011 WL 2292302, *7 n.5 (N.D. Ill. 2011) (finding oral modification invalid where bank rejected modification and purported modification was not supported be independent consideration); *Travel Services Network, Inc. v. Presidential Financial Corp. of Massachusetts*, 959 F. Supp. 135 (D. Conn. 1997) (holding that borrower failed to establish subsequent oral modification where borrower provided no evidence that valid consideration passed from borrower to lender for alleged modification); *Watkins v. GMAC Financial Services*, 337 Ill. App. 3d 58, 271 Ill. Dec. 389, 785 N.E.2d 40, 50 U.C.C. Rep. Serv. 2d 899 (1st Dist. 2003) (holding that car owner did not validly modify contract to prepay car loan out of insurance proceeds in consideration of lender's surrendering title to car where lender did not agree to modify its obligations and, in exchange for release of title, owner was offering to do what she was already obligated to do under contract and did not offer any new consideration).

[4]*Betterton v. First Interstate Bank of Arizona, N.A.*, 615 F. Supp. 72 (E.D. Mo. 1985).

[5]*Betterton v. First Interstate Bank of Arizona, N.A.*, 800 F.2d 732, 1 U.C.C. Rep. Serv. 2d 1760 (8th Cir. 1986). See also Restatement Second, Contracts, § 73 (1981) (performance of legal duty owed to promisor is not consideration); *McCallum Highlands, Ltd. v. Washington Capital Dus, Inc.*, 66 F.3d 89, 93 (5th Cir, 1995), opinion corrected on denial of reconsideration, 70 F.3d 26 (5th Cir. 1995) ("In general, under the 'preexisting duty rule,' an agreement to do what one is already bound to do cannot serve as 'sufficient consideration to support a supplemental contract or modification,'") (internal citations omitted); *Ayres v. Parker*, 2013 WL 4048328, *11 (W.D. Tex. 2013) (noting no new contract or contract modification existed where the purported consideration was tender of amounts due under the existing loan).

modification provision.[6] In particular, such a provision may not be enforceable where the borrower detrimentally relied or partially performed based on the oral modification.[7] In *Towers Charter & Marine Corp. v. Cadillac Ins. Co.*,[8] however, the Second Circuit rejected the borrower's contention that the alleged oral modifications to a loan agreement were enforceable despite a no-oral-modification provision based on partial performance and detrimental reliance because under New York law, partial performance on an agreement to modify must be "unequivocally referable to the alleged modifications" and must not be conduct compatible with the original agreement. The court held that the $1 million of expenditures made by the borrower were not precluded under the loan agreement as written.

In addition to an oral modification, a contract may be modified by the parties' course of performance. For example, in *Alaska Statebank v. Fairco*,[9] the Alaska Supreme Court stated that "modification of a written

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[6]See *Cambridgeport Sav. Bank v. Boersner*, 413 Mass. 432, 439, 597 N.E.2d 1017, 1022 (1992) ("[A] provision that an agreement may not be amended orally but only by a written instrument does not necessarily bar oral modification of the contract"); see also *Grandonico v. Consortium Communications Intern., Inc.*, 566 F. Supp. 1288, 1291 (S.D. N.Y. 1983) ("[W]hen a written contract provides that it cannot be altered except in writing, it cannot be altered except in writing, subject to the narrow exception that if the parties agree orally to alter the contract, the oral agreement may be proven by partial performance of the oral agreement, but only if the performance is 'unequivocally referable to the oral agreement to modify' ") (internal citations omitted).

[7]See *Hamlin v. Steward*, 622 N.E.2d 535 (Ind. Ct. App. 1993) (holding that oral modification of promissory note, which had required annual installment payments, to create condition precedent that note makers sell motel before payment on note would be due, was enforceable under promissory estoppel; when note payees agreed to forbear from collecting on note until note makers sold motel, makers changed their plans in reliance upon that promise by not making annual payments on note, and payees were estopped from claiming oral modification was unenforceable); *Foster v. Mutual Sav. Ass'n*, 602 S.W.2d 98 (Tex. Civ. App. Fort Worth 1980) (holding that where borrowers took no action to cure default on original loan nor change their position in any manner in reliance on oral modification of original note, lender was not estopped from relying on statute of frauds so as to render unenforceable the oral modification). Cf. *Okeechobee Resorts, L.L.C. v. E Z Cash Pawn, Inc.*, 145 So. 3d 989, 995 (Fla. 4th DCA 2014) ("[A] party may enforce an alleged oral modification of a written contract which expressly requires that any modification be in writing . . . [where] the oral amendment was accepted and acted upon by the parties in such a manner as would work a fraud on either party to refuse to enforce it.") (internal citation omitted). But see *Village On Canon v. Bankers Trust Co.*, 920 F. Supp. 520 (S.D. N.Y. 1996) (holding that the acceptance of interest payments after the maturity data and failure institute foreclosure proceedings did not give rise to the equitable estoppel or partial performance exception to the no-oral-modification rule).

[8]*Towers Charter & Marine Corp. v. Cadillac Ins. Co.*, 894 F.2d 516 (2d Cir. 1990).

[9]*Alaska Statebank v. Fairco*, 674 P.2d 288, 37 U.C.C. Rep. Serv. 1782 (Alaska 1983).

contract may be effected either through subsequent conduct or oral agreements." The court then upheld the trial court's determination that "given the course of dealing between the parties, the fact of the continued negotiation and the lack of outstanding demand for payment" the loan was not in default on the date of repossession and that the lender was liable for punitive damages based on wrongful repossession of the collateral. Conversely, in *Flagship Nat. Bank v. Gray Distribution Systems, Inc.*,[10] the court held that the lender's conduct in loaning the borrower funds in excess of the express lending limit provided in the note did not result in a modification since the express terms of a loan override any inconsistent interpretation which might be inferred from the parties' course of performance. Further, a court may refuse to enforce such modification where the contract requires modifications in writing.[11]

### § 174:12 Willful failure to account for modified terms under a bankruptcy plan

Plans confirmed by a debtor under either Chapter 11, 12 or 13 of the Bankruptcy Code will often change the payment terms under the original loan with a lender. This creates a problem for many lenders in monitoring the payments because if the lenders is unable to modify the payment terms in its internal monitoring systems, the lender will not be able to easily determine when the debtor is in default under the debtor's plan.

The 2005 Amendments made this dilemma, more serious by the addition of Code § 524(i). That provision states that a creditor who willfully fails to properly credit payments received under a confirmed plan will be deemed to have violated the discharge injunction under Code § 524(a)(2) if such failure to properly credit the payments caused "material injury to the debtor." Although the failure must be "willful" and the injury must be "material," nevertheless this provision should motivate lenders to adjust their, accounting systems to ensure that false defaults under the debtor's modified terms are not automatically noticed to the debtor.

## C. BREACH OF THE DUTY OF GOOD FAITH

[10] *Flagship Nat. Bank v. Gray Distribution Systems, Inc.*, 485 So. 2d 1336, 1 U.C.C. Rep. Serv. 2d 601 (Fla. 3d DCA 1986).

[11] See, e.g., *Pioneer Capital Corp. v. Environamics Corp.*, 2003 WL 345349, *10 (D. Me. 2003), decision aff'd, 2003 WL 1923765 (D. Me. 2003) (finding borrower in default where loan document required modifications to be in writing despite lender's act of forbearance).

## § 174:13 Generally

Every contract, including a contract to loan money, includes an implied duty of good faith.[1] The purpose of this duty is to assist the parties in fulfilling their reasonable expectations and to prevent opportunistic behavior.[2]

## § 174:14 Standard

The courts vary as to whether the standard for determining good faith is objective or subjective or both. Courts holding that the parties' actions are judged on an objective standard often cite to Section 205 of the Restatement (Second) of Contracts, Comment (d),[1] which states:

> Subterfuges and evasions violate the obligation of good faith in performance even though the actor believes his conduct to be justified. But the obligation goes further; bad faith may be overt or may consist of inaction, and fair dealing may require more than honesty. . . .

Under this standard the focus is on whether the party acted reasonably under the circumstances.[2] In contrast, some courts refer to the definition of good faith in § 1-201(19) of the Uniform Commercial Code ("U.C.C."). The U.C.C. defines good faith as "honesty in fact" and

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[Section .13]

[1]See, e.g., *Schaeffer v. JP Morgan Chase Bank, N.A.*, 2017 WL 8220239, *6 (D. Idaho 2017), report and recommendation adopted, 2018 WL 1278189 (D. Idaho 2018) ("The Idaho Supreme Court recognizes there is an implied in law covenant of good faith and fair dealing in every contract. *Idaho First Natl. Bank v. Bliss Valley Foods*, 824 P.2d 841, 862 (Idaho 1991). The covenant is breached by "fairly action by either party which violates, nullifies or significantly impairs any benefit of the contract," and requires "that the parties perform in good faith the obligations imposed by their agreement." 824 P.2d at 863. However, a breach of this covenant results in contract damages, not tort damages. 824 P.2d at 863. And, "[t]he implied covenant of good faith and fair dealing arises only regarding terms agreed to by the parties." *Bushi v. Sage Health Care, PLLC*, 203 P.3d 694, 698 (Idaho 2009). "There is no basis for claiming implied terms contrary to the express rights contained in the parties' agreement," *Idaho First Nat'l Bank*, 824 P.2d at 863. In other words, the covenant "does not create new duties that are not inherent" in the parties' agreement. *Wesco Autobody Supply, Inc. v. Ernest*, 243 P.3d 1069, 1080 (Idaho 2010).").

[2]See, generally, Posner, Economic Analysis of Law, § 4.1 (3d Ed. 1986).

[Section .14]

[1]E.g., *Savers Federal Sav. and Loan Ass'n v. Home Federal Sav. and Loan Ass'n*, 721 F. Supp, 940, 945 (W.D. Tenn. 1989); *Wells Fargo Realty Advisors Funding, Inc. v. Uioli, Inc.*, 872 P.2d 1359, 1363 (Colo. App. 1994).

[2]Restatement Second, Contracts § 205, comment a (1979) (focus is on the reasonable expectations of the parties).

is often referred to as the "pure-heart, empty-head" standard.[3] Courts holding that the parties' actions are judged based on a subjective standard generally cite to the U.C.C. Section 1-203 of the U.C.C, states that "[e] very contract or duty within this Act imposes an obligation of good faith in its performance or enforcement."

Other courts have applied an either/or standard.[4] This approach may be supported by § 1-103 of the U.C.C., which provides that: "Unless displaced by the particular provisions of this Act, the principles of law and equity . . . shall supplement its provisions."[5]

Finally, although the applicable standard for good faith is often academic, it can, in certain cases, determine liability. For example, in *K.M.C. Co., Inc. v. Irving Trust Co.*,[6] the court indicated that although the lender may not have been liable under a purely subjective standard, the lender was liable under an objective standard.

### § 174:15 Applicability

The duty of good faith generally applies where one party to the contract has the discretion to perform or request performance from the

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[3]E.g., *Continental Bank N.A. v. Modansky*, 997 F.2d 309, 313 (7th Cir. 1993); *Wainwright Bank & Trust Co. v. Railroadmens Federal Sav. & Loan Ass'n of Indianapolis*, 806 F.2d 146, 150 n.4, 4 U.C.C. Rep. Serv. 2d 1295 (7th Cir. 1986); *U.S. v. H & S Realty Co.*, 837 F.2d 1, 3, 5 U.C.C. Rep. Serv. 2d 539 (1st Cir, 1987).

[4]E.g., *Agriliance, L.L.C. v. Farmpro Services, Inc.*, 328 F. Supp. 2d 958, 52 U.C.C. Rep. Serv. 2d 36 (S.D. Iowa 2003); *K.M.C. Co., Inc. v. Irving Trust Co.*, 757 F.2d 752, 761, 1 Fed. R. Serv. 3d 1095, 92 A.L.R. Fed. 661 (6th Cir. 1985).

[5]See *Watseka First Nat. Bank v. Ruda*, 135 Ill. 2d 140, 142 Ill. Dec. 184, 552 N.E.2d 775, 781, 10 U.C.C. Rep. Serv. 2d 1073 (1990) (holding that § 1-103 incorporates an objective standard with the subjective standard of § 1-203); *Bank of China v. Chan*, 937 F.2d 780, 789, 15 U.C.C. Rep. Serv. 2d 162 (2d Cir. 1991) (citing both U.C.C. and Second Restatement in defining good faith); but see *U.S. Nat. Bank of Oregon v. Boge*, 311 Or. 550, 814 P.2d 1082, 1090, 15 U.C.C. Rep. Serv. 2d 24 (1991) (concluding that the subjective good faith standard contained in § 1-203 displaces the objection common law standard).

[6]*K.M.C. Co., Inc. v. Irving Trust Co.*, 757 F.2d 752, 761, 1 Fed. R. Serv. 3d 1095, 92 A.L.R. Fed. 661 (6th Cir, 1985).

other party.[1] The most famous case subjecting a lender's discretion to the duty of good faith is *K.M.C. Co., Inc. v. Irving Trust Co.*,[2] where the Sixth Circuit held that a lender violated the duty of good faith when it refused to advance funds to the borrower. The court held that the "obligation to act in good faith would require a period of notice to [the borrower] to allow it a reasonable opportunity to seek alternate financing, absent valid business reasons precluding [the bank] from doing so."[3]

The courts halve generally held, however, that a party to a contract does not violate the duty of good faith by taking actions expressly

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[Section .15]

[1]See *Chemical Bank v. Paul*, 244 Ill. App. 3d 772, 185 Ill. Dec. 302, 614 N.E.2d 436 (1st Dist. 1993) ("The exercise of good faith and fair dealing is particularly critical where, as here, the bank was granted considerable discretion in the use and application of the funds disbursed."); *Burkhardt v. City Nat. Bank of Detroit*, 57 Mich. App. 649, 652, 226 N.W.2d 678, 680 (1975) ("Where a party to a contract makes the manner of its performance a matter of its own discretion, the law does not hesitate to imply the proviso that such discretion be exercised honestly and in good faith."). Cf. *Transit Funding Associates, LLC v. Capital One Equipment Finance Corp.*, 149 A.D. 3d 23, 48 N.Y.S.3d 110, 114 (1st Dep't 2017) ("[C]ovenant of good faith and fair dealing cannot negate express provisions of the agreement nor is it violated where the contract terms unambiguously afford Capital One the right to exercise its absolute discretion to withhold the necessary approval.") (internal citation omitted).

[2]*K.M.C. Co., Inc. v. Irving Trust Co.*, 757 F.2d 752, 1 Fed. R. Serv. 3d 1095, 92 A.L.R. Fed. 661 (6th Cir. 1985).

[3]*K.M.C. Co., Inc. v. Irving Trust Co.*, 757 F.2d 752, 759, 1 Fed. R. Serv. 3d 1095, 92 A.L.R. Fed. 661 (6th Cir. 1985).

authorized in the contract.[4] For example, in *Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*,[5] the Seventh Circuit reversed the decision of two lower courts which equitably subordinated the bank's loan after the bank terminated the debtor's line of credit after five-days notice as provided in the loan agreement. In so holding, the Seventh Circuit stated:

> Firms that have negotiated contracts are entitled to enforce them to the letter, even to the great discomfort of their trading partners, without being mulcted for lack of "good faith.". . . When the contract is silent, principles of good faith. . . fill the gap. They do not block use of terms that actually appear in the contract.[6]

Conversely, other courts have held that a lender violated its duty of good faith by taking actions expressly authorized in the contract. For

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[4]E.g., *Hall v. Resolution Trust Corp.*, 958 F.2d 75, 79, 17 U.C.C. Rep. Serv. 2d 653 (5th Cir. 1992) (refusing to vary provisions of the loan agreement based on the duty of good faith); *In re Nantahala Village, Inc.*, 976 F.2d 876, 882, 23 Bankr. Ct. Dec. (CRR) 1025, Bankr. L. Rep. (CCH) P 74944, 18 U.C.C. Rep. Serv. 2d 1027 (4th Cir. 1992) (stating that a party to a loan agreement does not breach the good-faith obligation imposed by the U.C.C. when it exercises rights expressly authorized under the contract); *Needham v. The Provident Bank*, 110 Ohio App. 3d 817, 831-32, 675 N.E.2d 514, 523, 32 U.C.C. Rep. Serv. 2d 48 (8th Dist. Cuyahoga County 1996) ("Ohio courts, however, uniformly reject the holding in *K.M.C.*, and instead find that a lender does not *832 act in "bad faith" when it decides to enforce its contract rights."); *Renslow v. Capital One Bank (USA), N.A.*, 2009 WL 10666842, *4 (S.D. Fla. 2009), aff'd, 343 Fed. Appx. 457 (11th Cir. 2009) ("An implied duty of good faith cannot be used to override or modify explicit contractual terms,") (citing *Riggs Nat. Bank of Washington, D.C. v. Linch*, 36 F.3d 370, 373 (4th Cir. 1994)); *UniCredito Italiano SPA v. JPMorgan Chase Bank*, 288 F. Supp. 2d 485 (S.D. N.Y. 2003) (holding that "[a]lthough New York law implies a duty of good faith and fair dealing in every contract, 'no obligation can be implied that would be inconsistent with other terms of the contractual relationship.' "); *Travel Services Network, Inc. v. Presidential Financial Corp. of Massachusetts*, 959 F. Supp. 135, 141 (D. Conn. 1997) (holding that lender could not be held liable for breach of covenant of good faith for slowing rate at which it advanced money to borrower or declining to advance additional funds after certain date where lender "expressly reserved for itself the right to extend loans in its 'sole discretion. . .' "); *Cable & Associates Ins. Agency, Inc. v. Commercial Nat. Bank of Pennsylvania*, 2005 PA Super 186, 875 A.2d 361, 364 (2005) (holding that "a lending institution does not violate a separate duty of good faith by adhering to its agreement with the borrower or by enforcing its legal and contractual rights as a creditor").

[5]*Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351, 20 Bankr. Ct. Dec. (CRR) 1305, 23 Collier Bankr. Cas. 2d (MB) 1118, Bankr. L. Rep. (CCH) P 73565 (7th Cir. 1990).

[6]*Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*, 908 E2d 1351, 1357, 20 Bankr. Ct. Dec. (CRR) 1305, 23 Collier Bankr. Cas. 2d (MB) 1118, Bankr. L. Rep. (CCH) P 73565 (7th Cir. 1990).

example, in *Brown v. AVEMCO Inv. Corp.*,[7] the court held that a lender's right to accelerate a loan pursuant to provision authorizing acceleration if the borrower leased certain collateral without the lender's consent was subject to the implied duty of good faith. Finally, some courts have imposed tort liability based on a breach of the good-faith duty.[8]

### § 174:16 Applicability—Good-faith duty to negotiate open terms

A lender and a borrower do not have a contractual duty to each other to bargain in good faith prior to the formation of a contract.[1] However, once the parties enter into a contractual relationship, the borrower and the lender each have a duty to negotiate any open terms in good faith.[2] As the court in *Teachers Ins. and Annuity Ass'n of America v. Tribune Co*[3] explained:

> [a] binding preliminary commitment does not commit the parties to their ultimate contractual objective but rather to the obligation to negotiate the open issues in good faith in an attempt to reach the alternate objective within the agreed framework. In [a complete agreement], a party may lawfully demand performance

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[7] *Brown v. AVEMCO Inv. Corp.*, 603 F.2d 1367, 1377-1378, 28 Fed. R. Serv. 2d 407, 27 U.C.C. Rep. Serv. 885 (9th Cir. 1979). See also *Sterling Nat. Mortg. Co., Inc. v. Mortgage Corner, Inc.*, 97 F.3d 39 (3d Cir. 1996) (holding that claim could be stated for breach of the covenant of good faith and fair dealing even though mortgage network retained discretion to direct loans to particular lenders).

[8] See § .27.

[Section .16]

[1] See *First Nat. Bank of Chicago v. Atlantic Tele-Network Co.*, 946 F.2d 516, 520 (7th Cir. 1991) ("Granted, there is in general no duty to bargain in good faith over the terms of a contract (the loan agreement). . . But that is because parties have maximum bargaining freedom before a contract has been made inaugurating a relationship between them.").

[2] See, e.g.; *Teachers Ins. and Annuity Ass'n of America v. Ormesa Geothermal*, 791 F. Supp. 401, 415 (S.D. N.Y. 1991) ("[A] binding preliminary agreement [existed] that obligated the borrower and the lenders to seek to effectuate a final loan agreement upon the agreed terms by negotiating in good faith to resolve the other terms customarily found in such agreements."); *First Nat. Bank of Chicago v. Atlantic Tele-Network Co.*, 946 F.2d 516 (7th Cir. 1991) ("Once a contractual relation is formed, however—and it was formed here, as we have seen by the commitment and fee letters, which were contracts—the duty of good-faith performance enters the picture and requires bargaining in good faith over terms left open by the original contract; for that bargaining is a component of the anticipated performance."); see also *Brown v. Cara*, 420 F.3d 148, 157 (2d Cir. 2005) (explaining that under New York law, a preliminary (or "Type II") agreement "does not commit the parties to their ultimate contractual objective but rather to the obligation to negotiate the open issues in good faith") (internal citation omitted).

[3] *Teachers Ins. and Annuity Ass'n of America v. Tribune Co.*, 670 F. Supp. 491 (S.D. N.Y. 1987).

of the transaction even if no further steps have been taken following the making of the "preliminary" agreement. In [an agreement with open terms], he may not. What he may demand, however, is that his counterparty negotiate the open terms in good faith toward a final contract incorporating the agreed terms. This obligation does not guarantee that the final contract will be concluded if both parties comport with their obligation, as good faith differences in the negotiation of the open issues may prevent a reaching of final contract. It is also possible that the parties will lose interest as circumstances change and will mutually abandon the negotiation. The obligation does, however, bar a party from renouncing the deal, abandoning the negotiations, or insisting on conditions that do not conform to the preliminary agreement.

### § 174:17 Applicability—Good-faith duty to negotiate a refinancing agreement.

A lender does not have a contractual[1] good-faith duty to refrain from exercising its express rights pursuant to a loan agreement.[2] For example, in *Rosemont Gardens Funeral Chapel-Cemetary, Inc. v. Trustmark Nat. Bank*,[3] the court held that a bank did not breach duty of good faith given that it had no duty to negotiate with borrowers toward restructuring their loans, and if it did choose to negotiate with them, it was not unreasonable or unfair to propose that borrowers pay

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[Section .17]

[1]But see § .8, discussing tortious breach of duty of good faith.

[2]See, e.g., *Terry A. Lambert Plumbing, Inc. v. Western Sec. Bank*, 934 F.2d 976, 982, R.I.C.O. Bus. Disp. Guide (CCH) P 7780 (8th Cir. 1991) (holding that lender did not have any obligation to subordinate its position to enable the borrower to obtain accounts receivable financing); see also *Market Street Associates Ltd. Partnership v. Frey*, 941 F.2d 588, 594 (7th Cir. 1991) ("But even after you have signed a contract, you are not obliged to become an altruist toward the other party and relax the terms if he gets into trouble in performing his side of the bargain."); *Creeger Brick and Bldg. Supply Inc. v. Mid-State Bank and Trust Co.*, 385 Pa. Super. 30, 560 A.2d 151, 154, 9 U.C.C. Rep. Serv. 2d 438 (1989) (finding that lender did not breach its duty of good faith in refusing to make a working capital loan or in refusing to release its lien on the borrower's residence or to sell 90% of its loan so that the borrower could, obtain a working capital loan from another lender); *Badgett v. Security State Bank*, 116 Wash. 2d 563, 807 P.2d 356, 14 U.C,C. Rep, Serv. 2d 385 (1991) (holding that lender was not obligated under the implied duty of good faith to consider the debtor's restructuring proposal and that the loan officer's agreement to present the proposal to the loan committee did not create an enforceable obligation to negotiate); *LaSalle Business Credit, Inc. v. Lapides*, 2003 WL 722237 (N.D. Ill. 2003) (holding that lender's choice not to renegotiate the terms of loan was not bad faith).

[3]*Rosemont Gardens Funeral Chapel-Cemetary, Inc. v. Trustmark Nat. Bank*, 330 F. Supp. 2d 801 (S.D. Miss. 2004).

down loan by liquidating other assets as condition to lowering borrowers' payments.

Liability for refusal to negotiate a refinancing agreement in good faith may be found, however, if the parties formed a contract to restructure a loan and that was sufficiently definite to be enforced.[4] Moreover, recovery may be available on a promissory estoppel theory if the lender falsely represented that it would restructure the loan and the borrower properly relied on that representation.[5] Parties may contract around such liability, however, in advance of refinancing negotiations.[6]

### § 174:18 Applicability—Good-faith duty when terminating a loan

A lender is subject to the implied duty of good faith in accelerating a note pursuant to an "at will" provision. Section 1-309 of the U.C.C. provides that:

> A term providing that one party or that party's 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, means that the party shall have the power to do so only if he in good faith believes that the prospect of payment or performance is impaired. . . .

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[4]Cf. *Richter, S.A. v. Bank of America Nat. Trust and Sav. Ass'n*, 939 F.2d 1176, 1196, 16 U.C.C. Rep. Serv. 2d 681 (5th Cir. 1991) (reversing judgment on jury verdict that lender "breached an oral contract . . . to negotiate in good faith toward a reasonable restructur[ing]" since the agreement was too indefinite to enforce); see also *Donnelly v. Branch Banking and Trust Co.*, 971 F. Supp. 2d 495, 509 (D. Md. 2013) (barring the borrower's attempt to enforce an oral modification of the loan agreement under a Maryland statute requiring such agreements to be in writing).

[5]Cf. *American Viking Contractors, Inc. v. Scribner Equipment Co., Inc.*, 745 F.2d 1365, 1372, 39 U.C.C. Rep. Serv. 1354 (11th Cir. 1984) (holding that restructuring agreement was too indefinite to be enforced and, consequently, incapable of satisfying the inducement element necessary to establish estoppel).

[6]See, e.g., *Bank of America, N.A, v. Corporex Realty & Investment Corporation*, 661 Fed. Appx. 305, 311 (6th Cir. 2016) (finding contract that discharged liability arising from loan communications to serve as bar of breach of good faith claim); see also *In re CMR Mortg. Fund, LLC*, 416 B.R. 720 (Bankr. N.D. Cal. 2009) (finding conduct of senior lender on real estate development loan, in accepting extension fee and then refusing to extend maturity date of loan, was expressly permitted by parties' agreements, precluding junior lender's claims against senior lender under New York law for breach of contract and breach of implied covenant of good faith and fair dealing; neither parties' co-lender agreement nor credit agreement conditioned acceptance of fee upon extension, of loan, or required senior lender to return fee if it elected not to extend loan, and pre-negotiation agreement expressly permitted senior lender to accept fee without extending loan).

The courts vary regarding whether good faith in this context is objective or subjective.[1] Some courts have expanded § 1309 to include other "default" acceleration clauses,[2] while others have held that the good-faith provision does not apply to acceleration based on an event of default specified in the loan agreement.[3] Similarly, several courts have held that good faith does not apply to demand notes.[4] However, where the loan agreement, although nominally labeled a "demand note," contains various default provisions that otherwise condition the lender's

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[Section .18]

[1]Compare *Watseka First Nat. Bank v. Ruda*, 135 Ill. 2d 140, 142 Ill. Dec. 184, 552 N.E.2d 775, 781, 10 U.C.C. Rep. Serv. 2d 1073 (1990) (applying modified subjective standard and collecting cases); with *U.S. v. Grayson*, 879 F.2d 620, 623 n.4, 10 U.C.C. Rep. Serv. 2d 1144 (9th Cir. 1989) (applying objective standard); see also *Engram v. JPMorgan Chase Bank*, 2010 WL 3447390, *3 (Ariz. Ct. App. Div. 1 2010) (noting that under Arizona commercial code, " '[g]ood faith' means honesty in fact and the observance of reasonable commercial standards of fair dealing").

[2]See, e.g., *Brown v. AVEMCO Inv. Corp.*, 603 F.2d 1367, 1370, 28 Fed. R. Serv. 2d 407, 27 U.C.C. Rep. Serv. 885 (9th Cir. 1979) (finding lower court in error where it refused to instruct that acceleration could only be done if defendant believed in good faith that its security interest was impaired by the breach of the security agreement and remanding for new trial).

[3]See, e.g., *Bowen v. Danna*, 276 Ark. 528, 533, 637 S.W.2d 560, 564, 34 U.C.C. Rep. Serv. 1095 (1982) (holding Arkansas "at will" termination provision requiring good faith "is inapplicable where the right to accelerate is conditioned upon the occurrence of an event, such as a lapse of required insurance coverage, which is in the complete control of the debtor."); see also *Engram v. JPMorgan Chase Bank*, 2010 WL 3447390, *5 (Ariz. Ct. App. Div. 1 2010) (collecting cases). See, generally, Anderson, Uniform Commercial Code, 3d Edition, § 1-208:42.

[4]See, e.g., *Reger Development, LLC v. National City Bank*, 592 F.3d 759, 764 (7th Cir. 2010), as amended, (Dec. 16, 2010) ("While Illinois law generally holds that 'a covenant of fair dealing and good faith is implied into every contract absent express disavowal,' the duty to act in good faith does not apply to lenders seeking payment on demand notes.") (internal citations omitted); *Union Bank v. Car Mart Auto Group, Inc.*, 2012-Ohio-5944, 91 15, 79 U.C.C. Rep. Serv. 2d 369 (Ohio Ct. App. 3d Dist. Putnam County 2012) (same, under Ohio law); *Taggart & Taggart Seed, Inc. v. First Tennessee Bank Nat. Ass'n*, 684 F. Supp. 230, 235, 7 U.C.C. Rep. Serv. 2d 363 (E.D. Ark. 1988), judgment aff'd, 881 F.2d 1080 (8th Cir. 1989) (same, analyzing UCC and Tennessee corollary); see also Official Comment to § 1-309 ("Obviously this section has no application to demand instruments or obligations whose very nature permits call at any time with or without reason.").

ability to accelerate or demand payment on the note, the obligation of good faith may apply to the lenders demand for repayment.[5]

## II. TORT LIABILITY

### § 174:19 Fiduciary duties

A lender does not generally owe fiduciary duties to a borrower.[1] A lender and borrower are typically viewed as having a debtor-creditor relationship where the parties are free to bargain at arm's length over the terms of a financing agreement.[2] This view is supported by the observation that a general imposition of a fiduciary duty on lenders would decrease the funds available to borrowers and would significantly increase the cost of those funds.[3]

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[5]See, e.g., *Bank One, Texas, N.A. v. Taylor*, 970 F.2d 16, 30-32, 23 Fed. R. Serv. 3d 870, 20 U.C.C. Rep. Serv. 2d 732 (5th Cir. 1992); but see *Reger Development, LLC v. National City Bank*, 592 F.3d 759 (7th Cir. 2010), as amended, (Dec, 16, 2010); cf. *Regions Bank v. Thomas*, 422 S.W.3d 550, 558, 80 U.C.C. Rep, Serv. 2d 70 (Tenn. Ct. App. 2013) (analyzing whether lender acting in good faith by accelerating loan and repossessing collateral and determining based on facts that actions taken were made in good faith, as a result of borrower's breach of condition in contract).

[Section .19]

[1]See, e.g., *Schaeffer v. JP Morgan Chase Bank, N.A.*, 2017 WL 8220239, *5 (D. Idaho 2017), report and recommendation adopted, 2018 WL 1278189 (D. Idaho 2018) ("[T]he weight of authority in mortgage foreclosure cases instructs no relationship of trust or confidence arises between a borrower and a financial institution acting as a lender. 'Courts have repeatedly held that a lender owes no fiduciary duties to a borrower absent exceptional circumstances, such as when a special relationship exists between the two parties.' "); *Larson v. Homecomings Financial, LLC*, 680 F. Supp. 2d 1230, 1234 (D. Nev. 2009); see also *Yerington Ford, Inc. v. General Motors Acceptance Corp.*, 359 F. Supp. 2d 1075, 1090 (D. Nev. 2004), decision rev'd on other grounds, 494 F.3d 865 (9th Cir. 2007) (holding that the Nevada Supreme Court "would hold that an arms-length lender-borrower relationship is not fiduciary in nature, absent exceptional circumstances"); *BHC Interim Funding, L.P. v. Finantra Capital, Inc.*, 283 F, Supp. 2d 968 (S.D. N.Y. 2003) (collecting cases under California and New York law).

[2]See *Vornado PS, L.L.C. v. Primestone Inv. Partners, L.P.*, 821 A.2d 296, 322, 49 U.C.C. Rep. Serv. 2d 1348 (Del. Ch. 2002), judgment aff'd, 822 A.2d 397 (Del. 2003) ("[U]nder New York law 'no fiduciary duty aris[es] out of the contractual arms' length debtor and creditor relationship' between a borrower and a lender.") (internal citations omitted); *Dallaire v. Bank of America, N.A.*, 367 N.C. 363, 368, 760 S.E.2d 263, 266 (2014) ("Ordinary borrower-lender transactions, by contrast, are considered arm's length and do not typically give rise to fiduciary duties.") (internal citations omitted).

[3]See *Williams v. Federal Land Bank of Jackson*, 954 F.2d 774, 777 (D.C. Cir. 1992) ("The costs of lending would rise sharply if lenders were obliged to give their borrowers' interests the sort of priority inherent in a fiduciary duty.").

There are circumstances, however, in which a lender-borrower relationship may give rise to a fiduciary relationship.[4] If the lender is deemed a fiduciary of the borrower, the lender is no longer free to bargain at arm's length but, conversely, is under a legal duty to act for the benefit of the borrower.[5] The nature of a fiduciary relationship between a lender and borrower was summarized in *Denison State Bank v. Madeira*,[6] where the Kansas Supreme Court stated that: A fiduciary relationship imparts a position of peculiar confidence placed by one individual in another. A fiduciary is a person with a duty to act primarily for the benefit of another. A fiduciary is in a position to have and exercise, and does have and exercise influence over another. A fiduciary relationship implies a condition of superiority of one of the parties over the other.[7]

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[4]See, e.g., *Dallaire v. Bank of America, N.A.*, 367 N.C. 363, 368, 760 S.E.2d 263, 266 (2014) ("[B]ecause a fiduciary relationship may exist 'under a variety of circumstances,' it is possible, at least theoretically, for a particular bank-customer transaction to 'give rise to a fiduciary relation given the proper circumstances.' ") (internal citations omitted); *Cowan Bros., L.L.C. v. American State Bank*, 2007 SD 131,91 26, 743 N.W.2d 411, 420 (S.D. 2007) ("[T]his Court has recognized that a fiduciary duty may arise between a lender and a borrower if there is a relationship of trust and confidence"); *In re Gluth Bros. Const., Inc.*, 424 B.R. 379, 391 (Bankr. N.D. Ill. 2009) ("[U]nder certain circumstances a lender "may create a fiduciary relationship by exercising improper control over a borrower.").

[5]See *In re Gluth Bros. Const., Inc.*, 424 B.R. 379, 391 (Bankr, N.D. 2009) ("[I]f 'the lending institution usurps the power to make business decisions from the customer's board of directors or officers, then it must also undertake the fiduciary obligations that officers and directors owe the corporation.') (citing *In re K Town, Inc.*, 171 B.R. 313, 320, 31 Collier Bankr, Cas. 2d (MB) 1340 (Bankr. N.D. Ill. 1994)).

[6]*Denison State Bank v. Madeira*, 230 Kan. 684, 230 Kan. 815, 640 P.2d 1235 (1982).

[7]*Denison State Bank v. Madeira*, 230 Kan, 684, 230 Kan. 815, 640 P.2d 1235, 1241-1242 (1982) (emphasis omitted).

A lender may be deemed a fiduciary in the context of certain special relationships.[8] A lender may also be deemed a fiduciary in the context of a lender-borrower relationship under special circumstances, such as where the parties do not bargain at arm's length, including where (1) the lender receives confidential information from the borrower, (2) the lender provides financial advice that the borrower relies on, or (3) the lender is in control of the borrower.[9] A lender that receives confidential information from a borrower may be deemed a fiduciary of the borrower subject to liability for misuse of that information. For example, in

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[8]See, e.g., *Ploog v. HomeSide Lending, Inc.*, 209 F. Supp. 2d 863 (N.D. Ill. 2002) ("[M]ismanagement of an escrow may give rise to a cause of action for a breach of fiduciary duty.") (internal citation omitted); see also *First Independent Bank of Nevada v. Mohave State Bank*, 2010 WL 1408890, *6 (D, Ariz. 2010) ("The relationship between the lead and participating lender can, as a matter of contract, give rise to the imposition of fiduciary duties. See *Women's Federal Sav. and Loan: Ass'n v. Nevada Nat. Bank*, 811 F.2d 1255, 1255 (9th Cir, 1987) (holding that provision in loan participation agreement that read defendant was to act "as a trustee with fiduciary duties" created fiduciary duty in loan participation, agreement). Yet, a fiduciary duty should not be inferred into a participatory loan agreement between sophisticated parties absent unequivocal language."); *Adams v. Federal Deposit Insurance Corporation*, 2011 WL 13228992, *4 (W.D. Wash. 2011) (noting a fiduciary duty may arise in a borrower-lender relationship where a joint venture exists). Cf. *Layne v. Bank One, Ky., N.A.*, 395 F,3d 271, 55 U.C.C. Rep. Serv., 2d 704, 2005 FED App. 0010P (6th Cir. 2005) (holding that loan agreement authorizing lender "as my agent and attorney in fact" to buy, sell or trade borrowers' pledged securities did not create fiduciary relationship); *Vornado PS, L.L.C. v. Primestone Inv. Partners, L.P.*, 821 A.2d 296, 49 U.C.C. Rep. Serv. 2d 1348 (Del. Ch. 2002), judgment aff'd, 822 A.2d 397 (Del. 2003) (holding that lender's appointment to be attorney-in-fact for purposes of protecting its interest in limited partnership units serving as collateral for its loans, and "no shop" and "first offer" provisions in loans did not by virtue of the amount of control lender exercised over borrower create a fiduciary duty under New York law that lender owed to borrower, since power of attorney-in-fact only was intended to protect lender's interest in the collateral and was not held for benefit of borrower).

[9]See *Wil-Roye Inv. Co. II v. Washington Mut. Bank, FA*, 142 S.W.3d 393, 410 (Tex. App. El Paso 2004) ("When a special relationship between a borrower and lender has been found, it has rested on extraneous facts and conduct, such as excessive lender control over, or influence in, the borrower's business activities."); *Dykstra v. Page Holding Co.*, 2009 SD 38, 766 N.W.2d 491, 497 (S.D. 2009) ("[A] bank and its borrower can become a fiduciary relationship only if (1) the borrower reposes faith, confidence, and trust in the bank, (2) the borrower is in a position of inequality, dependence, weakness, or lack of knowledge, and (3) the bank exercises dominion, control, or influence over the borrower's affairs.") (internal citations omitted); but see *Denison State Bank v. Madeira*, 230 Kan. 684, 230 Kan. 815, 640 P.2d 1235 (1982) (finding no fiduciary duty between a lender and borrower, because it was not "a situation where a party with superior knowledge used that knowledge to its own benefit to the detriment of the Other party who occupied an inferior position without the knowledge, expertise or ability to ascertain the true facts" and finding that borrower had responsibility to investigate public record).

*Steelvest, Inc. v. Scansteel Service Center, Inc.*,[10] the Kentucky Supreme Court held that a material issue of fact existed as to whether a lender owed fiduciary duties to the borrower where the borrower furnished the bank with confidential information regarding his business plans and whether the bank breached these duties in using the information to finance a competitor of the borrower.[11] A lender that provides financial advice to a borrower which the borrower relies on may be deemed a fiduciary of the borrower. For example, in *Deist v. Wachholz*,[12] the Supreme Court of Montana held that the lender was a fiduciary of the borrower where the lender acted as the borrower's financial advisor and the borrower relied upon the lender's advice in selling certain real estate owned by the borrower. Finally, a lender may be deemed a fiduciary of the borrower if it controls the borrower. The courts, however, have generally refused to impose fiduciary duties on the lender unless it was in charge of the borrower's day-to-day management. For example, in *In re Adelphia Communications Corp.*,[13] the court explained that "a lender may owe a fiduciary duty to a borrower if the lender gains substantial control over the borrower's business affairs. Control over the borrower is demonstrated when there is evidence that the lender was involved in the actual day-to-day management and operations of the borrower, or had the ability to compel the borrower to engage in unusual transactions." The court found no fiduciary relationship existed where there had been no evidence of the bank's control over the debtor-borrower, but rather only evidence of the bank's assistance to the directors of the debtor-borrower, which was insufficient to state a claim.

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[10] *Steelvest, Inc. v. Scansteel Service Center, Inc.*, 807 S.W.2d 476, 486 (Ky. 1991).

[11] *Whitney v. Citibank, N.A.*, 782 F.2d 1106 (2d Cir. 1986) (lender liable for aiding and abetting borrower in breaching its fiduciary duties).

[12] *Deist v. Wachholz*, 208 Mont, 207, 678 P.2d 188 (1984).

[13] *In re Adelphia Communications Corp.*, 365 B.R. 24, 63 (Bankr. S.D. N.Y. 2007), aff'd in part, 390 B.R. 64 (S.D. N.Y, 2008), adhered to on reconsideration, 2008 WL 1959542 (S.D. N.Y. 2008).

Courts will typically require control extending to day-to-day management of the debtor before imposing fiduciary duties on a lender.[14]

## § 174:20 Negligence

"As a general rule, a financial institution owes no duty of care to a borrower when the institution's involvement in the loan transaction does not exceed the scope of its conventional role as a mere lender of money."[1] However, a lender may be liable to a borrower for negligence where (1) the lender owes a duty of care to the borrower, (2) the lender breaches that duty, (3) the borrower suffers damage, and (4) the lender's breach is the actual and proximate cause of the damage.[2] Depending upon the jurisdiction, a lender may be able to assert contributory or comparative negligence as a valid defense to a claim of negligence.[3]

Courts generally are reluctant to find that a lender owes a duty of care to a loan applicant with whom the lender does not yet have a

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[14]See, e.g., *In re K Town, Inc.*, 171 B.R. 313, 319-20, 31 Collier Bankr. Cas. 2d (MB) 1340 (Bankr. N.D. Ill. 1994) (stating that lender may be deemed a fiduciary by exercising control sufficient to dictate corporate policy and the disposition of assets); *Wil-Roye Inv. Co. II v. Washington Mut. Bank, FA*, 142 S.W.3d 393 (Tex. App. El Paso 2004) (holding that evidence that borrowers were bank customers, had substantial deposits in bank, were shareholders in bank, and had often sought bank's advice on various matters did not demonstrate that lender had excessive control over or influence over borrowers sufficient to create a fiduciary relationship); *In re W.T. Grant Co.*, 699 F.2d 599, 609 (2d Cir. 1983) ("We entirely agree with his conclusion that '[a] creditor is under no fiduciary obligation to its debtor or to other creditors of the debtor in the collection of its claim' ") (internal citations omitted); *Union State Bank v. Woell*, 434 N.W.2d 712, 8 U.C.C. Rep. Serv. 2d 6 (N.D. 1989) (holding that bank was not a fiduciary where it did not exercise control over debtor "beyond the normal incidents of a debtor-creditor relationship").

[Section .20]

[1]*Alvarez v. BAC Home Loans Servicing, L.P.*, 228 Cal. App, 4th 941; 945, 176 Cal. Rptr. 3d 304, 307 (1st Dist. 2014) (citing *Nymark v. Heart Fed. Savings & Loan Assn.*, 231 Cal, App. 3d 1089, 1095-1096, 283 Cal. Rptr. 53 (3d Dist. 1991).)

[2]See Speiser, Krause, & Gans, The American Law of Torts, §§ 1:8 to 1;14; see also *Jolley v. Chase Home Finance, LLC*, 213 Cal, App. 4th 872, 902, 153 Cal, Rptr; 3d 546, 570 (1st Dist. 2013), as modified on denial of reh'g, (Mar. 7, 2013) (holding that lender can be found negligent in its handling of a loan transaction within its conventional role as a lender of money).

[3]See Speiser, Krause, & Gafis, The American Law of Torts, §§ 12;1 et seq., 13:1 et seq.

contractual relationship.[4] However, a lender that has received a fee for processing the loan application may owe the potential borrower a duty to process the application with care in certain circumstances.[5] A lender may also be liable to a borrower and to certain third parties for negligence in issuing a loan,[6] although courts have generally held that a lender does not owe a duty of care to a party that is not in contractual privity with the lender unless there are unusual circumstances where

[4]See, e.g,, *Okoro v. Ocwen Loan Servicing, LLC*, 2016 WL 4555052 (D. Md. 2016) (holding that commercial lender owed no duty of reasonable care in processing commercial loan application from sophisticated borrower so that borrower could not recover in tort for lender's alleged negligent failure to close loan) (citing *Silver Hill Station Ltd. Partnership v. HSA/Wexford Bancgroup, LLC*, 158 F. Supp. 2d 631 (D. Md. 2001)); *Lueras v. BAC Home Loans Servicing, LP*, 221 Cal. App. 4th 49, 163 Cal. Rptr. 3d 804, 820 (4th Dist. 2013) (holding that "a loan modification is the renegotiation of loan terms, which falls squarely within the scope of a lending institution's conventional role as a lender of money."); *Nymark v. Heart Fed. Savings & Loan Assn.*, 231 Cal. App. 3d 1089, 283 Cal. Rptr. 53, 59 (3d Dist. 1991) (holding that lender did not owe a duty of care to the borrower in preparing an appraisal of the borrower's collateral).

[5]See *Jacques v. First Nat. Bank of Maryland*, 307 Md. 527, 515 A.2d 756 (1986) (holding that, due in part to the payment of an application fee, the bank owed the borrower a contractual and a concomitant tort duty to process the borrower's loan application with care); *High v. McLean Financial Corp.*, 659 F. Supp. 1561, 1570 (D.D.C. 1987) (because the lender accepted an application fee and guaranteed the borrower a certain interest rate, the lender would be liable in tort but not contract if it failed to process, the application with reasonable care) (citing *Jacques*); but see *Silver Hill Station Ltd. Partnership v. HSA/Wexford Bancgroup, LLC*, 158 F. Supp. 2d 631, 640 (D. Md. 2001) (analyzing *Jacques* and its progeny and ultimately holding that "a lender in Maryland owes no duty in tort to reasonably process a loan, absent extraordinary risk or particular vulnerability or dependency on the part of the borrower."). Cf. *Davis v. U.S. Bancorp*, 383 F.3d 761 (8th Cir. 2004) (holding that bank owed duty of care to prospective borrower who was already client and applied for prior loan, of kind to support negligent misrepresentation claim for statements made in connection with subsequent loan application, but ultimately finding no negligent misrepresentation occurred).

[6]See, e.g. *Connor v. Great Western Sav. & Loan Ass'n*, 69 Cal. 2d 850, 73 Cal. Rptr. 369, 447 13.2d 609, 620, 39 A.L.R.3d 224 (1968) (holding that a construction lender owed a duty of care to the home purchasers "to exercise reasonable care to protect them from seriously defective construction whether caused by defective plans, defective inspection, or both," based on the lender's position as an "active participant" in the home construction enterprise and its ability to exert significant control over the project); *DuQuoin State Bank v. Norris City State Bank*, 230 Ill. App. 3d 177, 172 Ill. Dec. 317, 595 N.E.2d 678, 682-83 (5th Dist. 1992) (holding that bank was liable for negligence when it incorrectly represented the ownership of certain property where other bank relied on that representation in making a loan to the borrower); but see *Roundtree Villas Ass'n, Inc. v. 4701 Kings Corp.*, 282 S.C. 415, 321 S.E.2d 46 (1984) (explaining that absent a contract, a lender has no common law duty to the builder, desPite period inspections it may make on a construction project to ensure its loan advancements are being made properly).

the lender exceeds normal lending operations.[7] Further, a lender may be found liable for improper administration of the loan, including failure to make disbursements in accordance with the terms of the loan.[8]

Lender liability claims for negligence may also be based on misrepresentations to a borrower. The requirements to establish liability based on a negligent misrepresentation are set forth in the Restatement (Second) of Torts, Section 552(1), which provides:

> One who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.

As indicated in the Restatement, liability for a misrepresentation by the bank must generally be based on an affirmative statement made by the lender. For example, in *DeBry v. Valley Mortg. Co.*,[9] the purchaser of an office building alleged that a construction lender breached a duty of care owed to the purchaser by failing to disclose construction defects and building code violations. The court rejected this argument and held

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[7]See *DeBry v. Valley Mortg. Co.*, 835 P.2d .1000, 1004 (Utah Ct, App. 1992) (collecting bases noting a disagreement over the holding in Connor and concluding that "[m]ost courts … have been unwilling to extend a duty in [instances where the third party had no contractual relationship with the lender or no interest in the property prior to the purchase contract] absent lender involvement that goes beyond a traditional lender role or where the lender misrepresents material facts to those third parties."); see also *L.J. Gibson, Beau Blixseth v. Credit Suisse AG*, 2016 WL 4033104, *12 (D. Idaho 2016), aff'd, 720 Fed. Appx. 860 (9th Cir. 2018) (noting that subsequent to *Connor*, "California enacted a statute limiting its reach, and that Nevada had passed a similar statute in response, and declining to extend *Connor's* ruling to claims arising in Idaho, Montana, Nevada, and the Bahamas).

[8]See, e.g., *Jolley v. Chase Home Finance, LLC*, 213 Cal. App. 4th 872, 901, 153 Cal. Rptr. 3d 546, 570 (1st Dist. 2013), as modified on denial of reh'g, (Mar. 7, 2013),("We see no reason why a negligent failure to fund a construction loan, or negligent delays in doing so, would not be subject to the same standard of care."); *Brunswick Bank & Trust Co. v. U.S.*, 707 F.2d 1355 (Fed. Cir. 1983) (holding that the bank was precluded from collecting on a government guarantee if the government could prove that the bank had negligently administered the loan during liquidation); but see *Adams v. Federal Deposit Insurance Corporation*, 2011 WL 13228992, *4 (W.D. Wash. 2011) ("Plaintiffs respond that courts have recognized a duty for banks to administer loans in a non-negligent manner. Plaintiffs' support for the existence of such a duty is two dated cases from outside the state of Washington and an undated treatise.").

[9]*DeBry v. Valley Mortg. Co.*, 835 P.2d 1000, 1008 (Utah Ct. App. 1992).

that a claim for negligent misrepresentation must be based on an affirmative and not an implied misrepresentation.[10]

A lender may also be liable for negligent misrepresentations regarding loan negotiations. For example, in Richter, S.A. v. Bank of America Nat. Trust and Sav. Ass'n,[11] the Fifth Circuit held that there was sufficient evidence to support a jury verdict that the lender negligently misrepresented it would negotiate in good faith toward a reasonable restructuring of the borrower's loans where the bank had previously decided to terminate the loan after the borrower's grapes were harvested and bottled as wine and, consequently, was liable for $1.2 million invested by the borrower to keep the winery operating during negotiations. Similarly, in *Stokes v. Wells Fargo Bank, N.A.*,[12] the court found that the plaintiff stated a claim for negligent misrepresentation under Massachusetts law against loan servicer by alleging that the servicer falsely represented to her that it was reviewing her mortgage for a loan modification in good faith, that it repeatedly fabricated reasons as to why she was ineligible for a loan modification, that she reasonably relied on those representations and lost opportunities to cure her default as a result, and that the servicer knew or should have known that the information it was giving was

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[10] See also *Arnson v. My Investing. Place L.L.C.*, 2013 WL 5724048, *5 (D. Utah 2013) ("Utah courts will not find a duty to speak where the parties deal at arm's length, and where the underlying facts are reasonably within the knowledge of both parties. Under such circumstances, the plaintiff is obliged to take reasonable steps to inform himself, and to protect his own interests.") (internal citation omitted); *Ancell v. U.S. Bank Trust, N.A.*, 2014 WL 2048200, *11 (W.D. Mo. 2014) (noting plaintiff must show that "information the speaker communicated was false" to assert a claim for negligent misrepresentation); *In re BCI Pancake House, Inc.*, 270 B.R. 15, 38 Bankr. Ct. Dec. (CRR) 186 (Bankr. D. Del. 2001) (holding that party that assisted Chapter 11 debtors in attempting to find loan for failing business was not liable where record was devoid of evidence that party made any representations concerning lender's status or ability to lend); *Baskin v. Mortgage and Trust, Inc.*, 837 S.W.2d 743, 748 (Tex. App. Houston 14th Dist. 1992), writ denied, (Feb. 3, 1993) (holding that lender was not liable for negligent misrepresentation where it "made no representations, promises, guarantees, warranties, or statement to them in connection with the purchase of their home"); *Spencer Companies, Inc. v. Chase Manhattan Bank, N.A.*, 81 B.R. 194, 6 U.C.C. Rep. Serv. 2d 330 (D. Mass. 1987) (holding that participation in negotiations regarding interim financing did not constitute a representation that the bank would continue to finance borrower's operations on a short-term basis); but see *Frame v. Boatmen's Bank of Concord Village*, 824 S.W.2d 491 (Mo. Ct. App. E.D. 1992) (holding lender liable for negligent misrepresentation where the loan officer "failed to exercise reasonable care in informing [the borrower] of all the existing contingencies which were to be met before the loan could be made").

[11] *Richter; S.A. v. Bank of America Nat. Trust and Sav. Ass'n*, 939 F.2d 1176, 1186-1187, 16 U.C.C. Rep. Serv. 2d 681 (5th Cir. 1991).

[12] *Stokes v. Wells Fargo Bank, N.A.*, 37 F. Supp. 3d 525 (D. Mass. 2014).

false.[13] However, a statement that a bank intends to lend money generally will not support a claim for negligent misrepresentation,[14] although a lender may be found liable for negligent misrepresentations

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[13]See also *Rockridge Trust v. Wells Fargo, N.A.*, 985 F. Supp. 2d 1110, 1128 (N.D. Cal. 2013) (finding lender liable on negligent misrepresentation theory where bank was shown to have no intention to modify a loan but induced borrower to take certain actions in furtherance of the modification). Cf. *Patton v. State Bank & Trust Co.*, 936 So. 2d 391 (Miss. Ct. App. 2006) (holding that bank's customer failed to show that bank made misrepresentation that bank would lend money to customer for renovations if customer purchased foreclosed building from bank when customer admitted that no specific loan amount, loan commitment, or loan terms were ever discussed between himself and bank, and customer failed to set forth important aspects of loan, such as repayment terms, interest rate, and collateral to secure loan).

[14]See, e.g, *Ancell v. U.S. Bank Trust, N.A.*, 2014 WL 2048200, *12 (W.D. Mo. 2014) ("Under Missouri law, a negligent misrepresentation claim cannot arise from a statement regarding the speaker's future intent … because it is impossible to be negligent in failing to ascertain the truth or falsity of one's own future intentions." . . . Plaintiffs' negligent misrepresentation claim is based on a statement of future intent and must be dismissed.") (internal citations omitted); *Edwards v. Ocwen Loan Servicing, LLC*, 2012 WL 844396, *6 (E.D. Tex. 2012) ("Plaintiffs' negligent misrepresentation allegation concerns only an alleged promise to do or refrain from doing something in the future. Namely, Plaintiffs complain that Defendants said they would give them a loan modification and told them they would not seek foreclosure. These allegations do not concern an existing fact and are not actionable as a claim for negligent misrepresentation.").

regarding whether a loan was approved[15] or was being considered for approval, where such statements fall outside the statute of frauds.[16]

## § 174:21 Fraud

A lender may be liable for fraud if (1) it makes a false representation of a material fact, (2) knowing that the representation is false or with reckless disregard for the truth of the representation, (3) with the intent of inducing another party to act or refrain from action, (4) which the other party relies on, and (5) which causes damage to the other party as a result of the reliance.[1] A representation is not actionable, however, if it constitutes an immaterial fact or merely opinions, puffing, or a

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[15]See, e.g., *Federal Land Bank Ass'n of Tyler v. Sloane*, 825 S.W.2d, 439, 440 (Tex. 1991) (holding that a lender breached its duty of care when it negligently misrepresented to the borrower that its loan application had been approved and was liable to the borrower for costs incurred in reliance on this representation); *First Federal Sav. & Loan Ass'n of Hamilton v. Caudle*, 425 So. 2d 1050, 1052, 37 A.L.R.4th 767 (Ala. 1982) (holding bank liable for negligent misrepresentations in telling borrower and builder that borrower's FHA loan had been approved).

[16]See *Barraza v. Bank of America, N.A.*, 2012 WL 12886438, *8 (W.D. Tex. 2012) ("Plaintiffs do not allege that Defendants agreed to modify the loan or promised not to foreclose on the home. Instead, Plaintiffs claim Defendants stated the modification application "was still being reviewed," This is not an agreement, but merely a representation not subject to the statute of frauds."), Cf. *Mark Andrew of Palm Beaches, Ltd. v. GMAC Commercial Mortg. Corp.*, 265 F. Supp. 2d 366 (S.D. N.Y. 2003), judgment aff'd, 96 Fed. Appx. 750 (2d Cir. 2004) (holding that borrowers' claim that lender fraudulently and negligently misrepresented its intention to provide commercial loan to borrowers was barred by statute of frauds applicable to credit agreements). Cf. *Tuscany, Inc. v. Paragon Capital Corp.*, 102 Wash. App. 1016, 2000 WL 1224796, *8 (Div. 1 2000) (finding that Plaintiff stated a claim for negligent misrepresentation even though a contract had not been formed between the parties regarding underwriting of an IPO because the misrepresentations went to the defendant's ability to underwrite the IPO, which were made before the written agreement setting for the agreement was entered into—so the negligence was not in misrepresentation of the defendant's intention to provide the loan, but rather its capacity and ability to do so).

[Section .21]

[1]See Restatement Second, Torts §§ 525 to 530 (1976); see also *Rush v. American Home Mortg., Inc.*, 2009 WL 4728971, *17 (D. Md. 2009) (noting elements of fraud under Maryland law: "1) that a representation made by a party was false; 2) that the defendant knew the representation was false or made the misrepresentation with such reckless indifference to truth as to impute knowledge and an intent to defraud; 3) that the misrepresentation was made for the purpose of deceiving the plaintiff; 4) that the plaintiff reasonably relied upon the misrepresentation; and 5) that the plaintiff suffered damage directly resulting from the misrepresentation"); *Fidelity Mortg. Co. of Texas v. Cook*, 307 Ark. 496, 821 S.W.2d 39, 42 (1991) (same, under Arkansas law).

promise to do an act in the future.[2] A fact is generally considered to be material if a reasonable person would consider it important in determining its choice of action in a particular transaction.[3] A lender may be liable if it makes representations of both opinion and fact. For example, in *Parker v. Columbia Bank*,[4] the court held that the lender's representations regarding its experience in loan administration and the builder's qualifications constituted opinions but that the lender's representations that it would permit construction draws only after inspecting the work and would provide the borrowers with a new builder if the present one defaulted constituted facts for which the lender could be liable.

A lender may be liable for fraud based on the omission of a material fact. For example, in *Fidelity Mortg. Co. of Texas v. Cook*,[5] the court held a lender liable to a building contractor for fraud in representing that it had issued a loan commitment to the buyer without disclosing that the buyer failed to pay the loan commitment fee or that the lender did not have sufficient net worth to make the loan by itself. However, some

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[2] *Watson v. CitiMortgage, Inc.*, 530 Fed. Appx. 322, 328 (5th Cir. 2013) (holding promises of future action to not be actionable); see also *Tatro v. Homecomings Financial Network, Inc.*, 2011 WL 240265, *2 (D. Nev. 2011) ("Nor can failure to disclose 'unsound lending and foreclosure practices' with respect to past loans and mortgages constitute fraud as to an unrelated loan."); *Timi v. Prescott State Bank*, 220 Kan. 377, 553 P.2d 315, 325 (1976) (holding that statements which were equivocal, vague, indefinite, and qualified by the statement "so far as I know" did not evidence an intent to misrepresent). But see *The Traders Bank v. Kollar*, 2008 WL 746693, *4 (S.D. W. Va. 2008) (noting that while representations as to the price of property may often be regarded as puffery or sales talk, in light of the facts of the case, such representations may give rise to claim for fraud).

[3] *Koch v. Koch Industries, Inc.*, 203 F.3d 1202, 1230-31, 53 Fed. R. Evid. Serv. 663, 46 Fed. R. Serv. 3d 204 (10th Cir. 2000) ("A fact is material if it is one to which a reasonable person would attach importance in determining his or her choice of action in the transaction involved.").

[4] *Parker v. Columbia Bank*, 91 Md. App. 346, 604 A.2d 521 (1992).

[5] *Fidelity Mortg. Co. of Texas v. Cook*, 307 Ark. 496, 821 S.W.2d 39 (1991).

jurisdictions require that the plaintiff demonstrate the defendant had a duty to disclose the material information.[6]

Further, although there is generally no legal obligation to respond to a credit inquiry, liability based on the omission of a material fact may also arise in responding to a credit inquiry.[7] In *Central States Stamping Co. v. Terminal Equipment Co., Inc.*,[8] the Sixth Circuit affirmed a jury verdict against a bank for fraudulent misrepresentation based on a response to a credit inquiry received from a party that was purchasing a machine from the bank's borrower. The bank gave a generally positive response, noting only that the borrower was undercapitalized, and did not disclose the existence of loan defaults. The court indicated that the bank could have declined to respond but, having undertaken to discuss the financial position of its borrower, the bank assumed a duty not to omit material information.[9]

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[6]See *Nissan Motor Acceptance Corp. v. Scialpi*, 94 A.D.3d 1067, 1067, 944 N.Y.S.2d 160 (2d Dep't 2012) (holding "the plaintiff must demonstrate that the defendant had a duty to disclose material information and failed to do so"); see also *Athey Products Corp. v. Harris Bank Roselle*, 89 F.3d 430 (7th Cir. 1996) (holding that bank's failure to warn borrower's unsecured creditor regarding borrower's shaky financial condition and its failure to terminate loan did not support unsecured creditor's fraud action against bank based on intentional omission or concealment of material fact); *Northern Trust Co. v. VIII South Michigan Associates*, 276 Ill. App. 3d 355, 212 Ill. Dec. 750, 657 N.E.2d 1095 (1st Dist. 1995) (holding that lenders had no duty to disclose to guarantors that loan they guaranteed was considered "troubled" by the lender, and therefore failure to disclose this information could not constitute fraud); *Brazell v. First Nat. Bank and Trust Co. of Rockford*, 982 F.2d 206, 208-09 (7th Cir. 1992) (holding that lender was not liable for failure to carefully monitor the borrower's collateral and consequent failure to discover and inform guarantors of discrepancies between borrower's records and inventory).

[7]See, e.g., *Brayton Chemicals, Inc. v. First Farmers State Bank of Minier*, 671 F.2d 1047, 1052, 33 U.C.C. Rep. Serv. 1067 (7th Cir. 1982) (holding lender liable for misrepresenting the borrowers' financial condition and failing to disclose material facts to induce the supplier to provide additional inventory to the borrower); cf. *Lease & Rental Management Corp. v. Arrowhead Central Credit Union*, 126 Cal. App. 4th 1052, 24 Cal. Rptr. 3d 483 (4th Dist. 2005) (holding that credit union, which had represented that potential borrower had satisfactory credit in response to lender's credit inquiry, was not liable in negligence to lender where inadequacy of credit reference request forms used by lender was root of problem, and overdrafts were small percentage of volume of checks processed by credit union).

[8]*Central States Stamping Co. v. Terminal Equipment Co., Inc.*, 727 F.2d 1405, 1409 (6th Cir. 1984).

[9]*Central States Stamping Co. v. Terminal Equipment Co., Inc.*, 727 F.2d 1405, 1409 (6th Cir. 1984). But see *United Jersey Bank v. Kensey*, 306 N.J. Super. 540, 556, 704 A.2d 38 (App. Div. 1997) (distinguishing Central States Stamping Co. and compiling contrary cases).

Liability based on the omission of a material fact may also arise based on representations made to other loan participants if the originating lender fails to make full disclosure to the participating lenders.[10] For example, in *Commercial Nat. Bank of Peoria v. Federal Deposit Ins. Corp.*,[11] the court upheld a jury verdict for fraud where the originating bank misled a correspondent bank by providing financial information but failing to advise the correspondent that the borrower had laid off all its employees, a potentially profitable contract had not been finalized, and the loan proceeds would be used to cover an overdraft with the originating bank. Similarly, in *Olney Sav. & Loan Ass'n v. Trinity Banc Sav. Ass'n*,[12] the Fifth Circuit upheld a jury verdict for fraud in favor of a bank with a 90% participation based on misrepresentations that certain loan-to-purchase price ratios would be maintained, that a certain number of homes would be owner-occupied, and that the originating bank would investigate the buyers and the condition of the town homes. The court also held that the originating bank was liable for fraud for sending inaccurate appraisals and sales contracts, which falsely indicated that down payments were made, and for concealing the facts that all town homes would be in the same project and that other loans in that project were already in default.

A lender may also be liable for promissory fraud based on a representation made by the lender without a present intent to perform

[10] *General Motors Acceptance Corp. v. Central Nat. Bank of Mattoon*, 773 F.2d 771, 789 (7th Cir. 1985) (affirming bank's liability to finance company for fraudulent misrepresentations and omissions regarding the borrower's financial condition); cf. *Union Nat. Bank of Little Rock v. Farmers Bank, Hamburg, Ark.*, 786 F.2d 881, 886, Blue Sky L. Rep., (CCH) P 72379, Fed. Sec. L. Rep. (CCH) P 92531 (8th Cir. 1986) (originating bank not liable for fraud where it did not know that its representations were false).

[11] *Commercial Nat. Bank of Peoria v. Federal Deposit Ins. Corp.*, 131 Ill. App. 3d 977, 87 Ill. Dec. 107, 476 N.E.2d 809, 812 (3d Dist. 1985); see also *Banque Arabe Et Internationale D'Investissement v. Maryland Nat. Bank*, 819 F. Supp. 1282 (S.D. N.Y. 1993), judgment affd, 57 F.3d 146 (2d Cir. 1995) (holding packaging bank liable for fraud for failure to disclose that necessary state agency approval had not been obtained due to superior knowledge not available to participating bank).

[12] *Olney Say. & Loan Ass'n v. Trinity Banc Sav. Ass'n*, 885 F.2d 266, 272-273 (5th. Cir. 1989).

as represented.[13] For example, in *Delzer v. United Bank*,[14] the Supreme Court of North Dakota reversed a lower court's dismissal of fraud claims based on the bank's false representation of an existing intention to perform under a potential agreement. Similarly, in *Sanchez-Corea v. Bank of America*,[15] the California Supreme Court affirmed a jury verdict against a lender based on fraud where the lender indicated that further financing might be forthcoming but only after the borrower assigned its accounts receivable to the lender and the lender then turned down the loan application one day after the assignment.

Finally, a lender may be liable for constructive fraud based on representations or omissions that, although not intended to mislead, resulted in a breach of a fiduciary duty to the borrower.[16] The existence of the fiduciary relationship is deemed to vitiate the requirement of fraudulent intent[17] and, consequently, in special circumstances even innocent misrepresentations may be deemed fraudulent.

### § 174:22 Deepening insolvency

Among the more controversial and debated areas of lender liability law is the tort of "deepening insolvency," which though once a potentially emergent area of liability, but is generally considered by

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[13]See, e.g., *Stirling v. Chemical Bank*, 382 F. Supp. 1146, Fed. Sec. L. Rep. (CCH) P 94810 (S.D. N.Y. 1974), opinion aff'd, 516 F.2d 1396 (2d Cir. 1975) (finding allegations that the lender induced the resignations of officers and directors of a borrower with fraudulent promises that the outstanding loan would not be called and further loans would be made stated a cause of action for fraud); *Union Nat. Bank of Little Rock v. Mosbacher*, 933 F.2d 1440, 1446 (8th Cir. 1991) (upholding a jury finding of fraud based on the bank's representation that a turn-around consultant would help the borrower when the lender actually intended for the consultant to liquidate the borrower's operations); see also Restatement Second, Torts §§ 527, 530 (1976).

[14]*Delzer v. United Bank*, 1997 ND 3, 559 N.W.2d 531 (N.D. 1997).

[15]*Sanchez-Corea v. Bank of America*, 38 Cal. 3d 892, 215 Cal. Rptr. 679, 701 P.2d 826, 838 (1985).

[16]See e.g., *Barrett v. Bank of America*, 183 Cal. App. 3d 1362, 229 Cal. Rptr. 16, 20 (4th Dist. 1986) (holding that evidence supported constructive fraud theory based on "quasi-fiduciary" relationship between lender and borrower); cf. *Union Nat. Bank of Little Rock v. Farmers Bank, Hamburg, Ark.*, 786 F.2d 881, 886, Blue Sky L. Rep. (CCH) P 72379, Fed. Sec. L. Rep. (CCH) P 92531 (8th Cir. 1986) (holding that doctrine of constructive fraud was not applicable to arm's-length transaction between originating and participating bank). But see *In re Off Dock USA, Inc.*, 2015 WL 3895538, *6-7 (B.A.P. 9th Cir. 2015), appeal dismissed, 2017 WL 6880086 (9th Cir. 2017) (calling into question the continuing validity of Barrett).

[17]See *Brazell v. First Nat. Bank and Trust Co. of Rockford*, 982 F.2d 206, 209 (7th Cir. 1992) ("It is also true that a fiduciary can be sued for constructive fraud, which does not require proof of deliberate falsity either"); *LaSalle Bank National Ass'n v. Mudd*, 2004 WL 407000 (N.D. Ill, 2004) ("Constructive fraud does not require actual dishonesty or intent to deceive; breach of fiduciary duty is enough").

courts to be merely a measure of damages under current case law.[1] "Deepening insolvency" generally refers to an action asserted by a representative of a bankruptcy estate against directors, officers, lenders, underwriters, accountants, and others based on their dealings with the debtor prior to bankruptcy. Under this theory of recovery, "[a] defendant may be liable for 'deepening insolvency' where the defendant's conduct, either fraudulently or even negligently, prolongs the life of a corporation thereby increasing the corporation's debt and exposure to creditors."[2] The phrase "deepening insolvency" was first raised by the Seventh Circuit in *Schacht v. Brown*,[3] and, in 2001, the Third Circuit issued a seminal decision in *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc.* upholding the validity of the theory as an independent tort.[4]

The tort of "deepening insolvency" was subsequently recognized by additional courts,[5] but others have viewed it simply as a theory of

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[Section .22]

[1]See *In re Oakwood Homes Corp.*, 340 B,R, 510, 527-28 (Bankr. D. Del. 2006) ("Courts and commentators have expressed divergent views about the theory of deepening insolvency. Indeed, courts do not agree whether deepening insolvency even exists. If it exists, however, many have struggled with whether it is simply a measure of damages or whether it is a distinct cause of action, Those that have determined that it is a cause of action are then faced with defining the elements and scope of the tort. Even once defined, there is debate about the proper measure of damages.").

[2]*In re LTV Steel Co., Inc.*, 333 B.R. 397, 421 (Bankr. N.D. Ohio 2005).

[3]*Schacht v. Brown*, 711 F.2d 1343, Fed. Sec. L. Rep. (CCH) P 99160 (7th Cir. 1983).

[4]*Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc.*, 267 F.3d 340, 349-50, 38 Bankr. Ct. Dec. (CRR) 147 (3d Cir. 2001) ("[T]o the extent that bankruptcy is not already a certainty, the incurrence of debt can force an insolvent corporation into bankruptcy, thus inflicting legal and administrative costs on the corporation . . .These harms can be averted, and the value within an insolvent corporation salvaged, if the corporation is dissolved in a timely manner, rather than kept afloat with spurious debt.").

[5]See, e.g., *In re Southwest Supermarkets, LLC*, 325 B.R. 417, 429, 44 Bankr. Ct. Dec. (CRR) 231 (Bankr. D. Ariz. 2005) (refusing to grant motion to dismiss "deepening insolvency" cause of action because the "complaint uses deepening insolvency as a measure of damages, not as a cause of action").

damages,[6] or even entirely duplicative of other tort claims,[7] and still other courts have rejected the theory outright and raised serious questions about its viability.[8]

The *Lafferty* holding has been significantly limited in applicability in recent years. In *In re Citx Corp., Inc.*,[9] the Third Circuit narrowed the *Lafferty* holding by limiting available claims to fraudulent conduct, disallowing deepening insolvency as a theory of damages, and restricting the tort to claims brought under Pennsylvania law. Less than a year later, the Delaware Chancery Court affirmatively rejected deepening insolvency as a standalone cause of action, stating: "Those federal courts that became infatuated with the concept [of deepening insolvency], did not look closely enough at the object of their ardor. . .none of those decisions explains the rationale for concluding that deepening insolvency should be recognized as a cause of action or how such recognition would be consistent with traditional concepts of fiduciary responsibility."[10]

## § 174:23 Defamation

A lender may be liable for defamation if it makes a false statement that "tends to harm the reputation of another as to lower him in the estimation of the community or to deter third persons from associating or dealing with him."[1] A bank may be liable for slander if the statement

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[6] *Schacht v. Brown*, 711 F.2d 1343, 1350, Fed. Sec. L. Rep. (CCH) P 99160 (7th. Cir. 1983); *Hannover Corp. of America v. Beckner*, 211 B.R. 849, 854 (M.D. La. 1997); *Allard v. Arthur Andersen & Co. (USA)*, 924 F. Supp. 488, 494, Fed. Sec. L. Rep. (CCH) P 99094, R.I.C.O. Bus. Disp. Guide (CCH) P 9029 (S.D. N.Y. 1996); *In re Latin Inv. Corp.*, 168 B.R. 1, 6 (Bankr. D. D.C. 1993).

[7] *In re National Century Financial Enterprises, Inc., Inv. Litigation*, 604 F. Supp. 2d 1128 (S.D. Ohio 2009) (dismissing deepening insolvency claim as duplicative of other causes of action under Ohio law); *In re Parmalat*, 383 F. Supp. 2d 587, 602 (S.D. N.Y. 2005) (same, under New York law); *In re Greater Southeast Community Hospital Corp.*, 333 B.R. 506, 517, 45 Bankr. Ct. Dec. (CRR) 179 (Bankr. D. D.C. 2005) (same, under the District of Columbia's law); *In re VarTec Telecom, Inc.*, 335 B.R. 631, 644, 45 Bankr. Ct. Dec. (CRR) 205 (Bankr. N.D. Tex. 2005) ("Much like the little old lady in the fast food commercials, the Court looks at the bottom of the deepening insolvency hamburger bun and is forced to ask 'where's the tort'?").

[8] See, e.g., *Florida Dept. of Ins. v. Chase Bank of Texas Nat. Ass'n*, 274 F.3d 924, 935-36 (5th Cir. 2001); *Feltman v. Prudential Bache Securities*, 122 B.R. 466, 473-74 (S.D. Fla. 1990).

[9] *In re CitX Corp., Inc.*, 448 F.3d 672, 46 Bankr. Ct. Dec. (CRR) 156, Bankr. L. Rep. (CCH) P 80602, 23 A.L.R.6th 891 (3d Cir. 2006).

[10] *Trenwick America Litigation Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168 (Del. Ch. 2006), judgment aff'd, 931 A.2d 438 (Del. 2007).

[Section .23]

[1] Restatement Second, Torts § 559 (1976).

is oral or for libel if the statement is written.[2] For example, in *Alaska Statebank v. Fairco*,[3] the Alaska Supreme Court held that a lender was liable for defamation based on the wrongful repossession of collateral, which the court held constituted a "statement" that impaired the borrower's relationships with its customers, clients, employees, business associates, and suppliers.

A claim for defamation may also arise in connection with a response to a credit inquiry.[4] In *Society Bank, N.A. v. Kellar*,[5] though, the court held that a lender was not liable for slander or libel since the lender did not make any oral statements to the credit bureau and the written statement that the borrower defaulted on the loan was true, which was a complete defense.

### § 174:24 Interference with contractual relationship

A lender may be liable for tortious interference with a contractual relationship if: (1) there is an enforceable contract, (2) the lender knows of the existence of the contract, (3) the lender intentionally and improperly interferes with the contract, which (4) induces ,a breach in the contract or makes performance more difficult, and (5) causes provable damages.[1]

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[2]See Restatement Second, Torts § 568 (1976).

[3]*Alaska Statebank v. Fairco*, 674 P.2d 288, 294-295, 37 U.C.C. Rep. Serv. 1782 (Alaska 1983).

[4]Cf. *Murungi v. Texas Guaranteed*, 693 F. Supp. 2d 597, 606-07, 257 Ed. Law Rep. 368 (E.D. La. 2010), aff'd, 402 Fed. Appx. 849 (5th Cir. 2010) (finding calls to borrowers workplace regarding default status of loan not defamatory per se); *In re Creditrust Corp.*, 283 B.R. 826, 831-32 (Bankr. D. Md. 2002) (finding no defamation where lender merely communicated with credit bureaus regarding alleged debts).

[5]*Society Bank, N.A. v. Kellar*, 63 Ohio App. 3d 583, 579 N.E.2d 717, 720 (2d Dist. Montgomery County 1989).

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[1]See Restatement Second, Torts §§ 766, 766A (1976).

A lender may, consequently, be liable where it requires the borrower to take action in breach of its contractual obligations as a condition to receiving a loan.[2]

### § 174:25 Interference with prospective advantage

A lender may be liable for tortious interference with prospective advantage under virtually the same circumstances as interference with contractual relationship except that: (1) a business expectancy is required instead of an existing enforceable contract, and (2) the lender's interference must be done with malice or an intent to harm:[1]

In the seminal case of *State Nat. Bank of El Paso v. Farah Mfg. Co., Inc.*,[2] the court held the lenders liable for interference with the borrower's business relations, explaining:

> [The borrower] was entitled to have its affairs managed by competent directors and officers who maintain a high degree of undivided loyalty to the company. . . The evidence is factually

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[2]See, e.g., *In re Cutty's-Gurnee, Inc.*, 133 B.R. 934, 966-967, 25 Collier Bankr. Cas. 2d (MB) 1524 (Bankr. N.D. Ill. 1991) (holding lender liable for causing the borrower to release first mortgage and assign its beneficial interest in land trust thereby causing borrower to breach its contractual obligation to other creditor to grant it a valid second mortgage); *First Wyoming Bank, Casper v. Mudge*, 748 P.2d 713 (Wyo. 1988) (finding a lender liable where the lender required the borrower to secure a loan with inventory and equipment of a business that the borrower was purchasing despite a clause in the purchase agreement, which was known to the lender, whereby the purchaser agreed not to encumber any of the business' assets until the purchase price was paid in full); *Lincor Contractors, Ltd. v. Hyskell*, 39 Wash. App. 317, 692 P.2d 903, 908 (Div. 1 1984) (upholding a damages award where a lender refused to disburse funds under a loan unless the general contractor was removed from the building project); cf. *Cordry v. Vanderbilt Mortg. & Finance, Inc.*, 370 F. Supp. 2d 923 (W.D. Mo. 2005), judgment aff'd, 445 F.3d 1106 (8th Cir. 2006) (holding that actions of lender, which were in accordance with lending contract, could not constitute tortious interference with contractual relationships); *Vornado PS, L.L.C. v. Primestone Inv. Partners, L.P.*, 821 A.2d 296, 49 U.C.C. Rep. Serv. 2d 1348 (Del. Ch. 2002), judgment aff'd, 822 A.2d 397 (Del. 2003) (holding that lender did not induce breach where borrower executed consent with potential refinancer that expressly waived such provision in order to permit potential refinancer to engage in discussions with lender regarding the possibility of joint proposal); *Taggart & Taggart Seed, Inc. v. First Tennessee Bank Nat. Ass'n*, 684 F. Supp. 230, 234, 7 U.C.C. Rep. Serv, 2d 363 (E.D. Ark. 1988), judgment aff'd, 881 F.2d 1080 (8th Cir. 1989) (dismissing a claim for tortious termination of a loan agreement and stating that "the defendant bank cannot be liable for tortious interference with a contract to which it is a party").

**[Section .25]**

[1]See Restatement Second, Torts § 766B (1976).

[2]*State Nat. Bank of El Paso v. Farah Mfg. Co., Inc.*, 678 S.W2d 661, 688-690, 40 U.C.C. Rep. Serv. 764 (Tex. App. El Paso 1984), writ granted, (Mar. 6, 1985) and judgment set aside, cause dismissed, (Mar. 6, 1985).

> sufficient that the interference compelled the election of directors and officers whose particular business judgment and inexperience and whose divided loyalty proximately resulted in injury to [the borrower]. The interference by the lenders was done willfully, intentionally, and without just cause or excuse. As a matter of law, [the borrower] has established a cause of action for interference.[160]

In *Hilgedick v. Koehring Finance Corp.*,[3] the court upheld an award of punitive damages against the lender based on interference with business relations where, after the lender negligently released its security interest in the borrower's assets, the lender "took over [the borrower] and milked [it] of its assets. . .] wrongfully withheld monies due to [a shareholder of the borrower] so that he would 'never. . . be able to afford this lawsuit' and interfered with [the shareholder's] efforts to obtain an alternative line of credit." Conversely, in *National Westminster Bank, U.S.A. v. Ross*,[4] the court held that the borrower failed to state a claim for tortious interference with prospective economic advantage because the borrower alleged that the bank's conduct was motivated by economic factors and not solely by malice.

## § 174:26 Duress

A lender may be liable for duress if it makes "a threat of unlawful conduct that is intended to prevent and does prevent another from

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[3] *Hilgedick v. Koehring Finance Corp.*, 8 Cal. Rptr. 2d 76, 84-85 (App. 1st Dist. 1992), reh'g denied and opinion modified, (May 14, 1992) and review granted and opinion superseded, 10 Cal. Rptr. 2d 183, 832 P.2d 899 (Cal. 1992) and review dismissed, cause remanded, (July 15, 1993).

[4] *National Westminster Bank, U.S.A., v. Ross*, 130 B.R. 656, 678, 16 U.C.C. Rep. Serv. 2d 272 (S.D. N.Y. 1991), aff'd, 962 F.2d 1 (2d Cir. 1992); see also *Pembroke Country Club, Inc. v. Regency Savings Bank, F.S.B.*, 62 Mass. App. Ct. 34, 815 N.E.2d 241 (2004) (holding that bank, member of lending consortium, did not employ improper means to obtain full payment of loan made to borrower who was attempting to negotiate for discounted loan payoff with other lenders, where lending agreement did not preclude bank from persuading others to abandon proposed settlement, bank's reference to policy of not granting discounts on loans was accurate, and cease and desist letter, which bank sent to other lenders, was means of enforcing provision that entitled bank to be sole negotiator).

exercising free will and judgment in his conduct."[1] In some jurisdictions, a threat of conduct that is not unlawful but is nonetheless "wrongful" can constitute duress.[2]

Duress more commonly is employed by a borrower as an affirmative defense to a contractual obligation rather than as an offensive weapon as a contract executed under duress is voidable.[3] Mere hard bargaining, however, does not generally give rise to duress.[4] For example, in *Federal*

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[Section .26]

[1]Restatement Second, Torts § 871, comment f (1977); see also Restatement Second, Contracts §§ 175, 176 (1979). See, e.g., *State Nat. Bank of El Paso v. Farah Mfg. Co., Inc.*, 678 S.W.2d 661, 674, 40 U.C.C. Rep. Serv. 764 (Tex. App. El Paso 1984), writ granted, (Mar. 6, 1985) and judgment set aside, cause dismissed, (Mar. 6, 1985) and judgment set aside, cause dismissed, (Mar. 6, 1985) (holding lenders liable for duress in threatening to push the borrower into "bankruptcy and padlock [the borrowing corporation] the next day" if the borrower elected a certain CEO).

[2]See, e.g., *Rich & Whillock, Inc. v. Ashton Development, Inc.*, 157 Cal. App. 3d 1154, 1160-61, 204 Cal. Rptr. 86 (4th Dist. 1984) (holding that bad-faith refusal by buyer to make final payment to seller unless the creditor accepted a compromised amount constituted duress where the creditor was known to be financially overextended to its own creditors and subcontractors and would be forced to file for bankruptcy without final payment); *Pecos Const. Co. v. Mortgage Inv. Co. of El Paso*, 1969-NMSC-134, 80 N.M. 680, 459 P.2d 842, 843 (1969) (upholding judgment for duress where a lender refused to honor its loan commitments unless the borrower paid an additional financing fee); but see *Ismert and Associates, Inc. v. New England Mut. Life Ins. Co.*, 801 F.2d 536, 551 (1st Cir. 1986) (holding that settlement agreement entered because the only alternative was bankruptcy was not voidable due to economic duress); *Synnex Corp. v. Wattles*, 2012 WL 5524953, *6-7 (N.D. Cal. 2012) (distinguishing Rich & Whillock and finding no duress based on the facts of the case).

[3]See, e.g., *Tibor Mach. Products, Inc. v. Freudenberg-Nok General Partnership*, 1996 WL 99896 (N.D. Ill, 1996) (holding that Illinois does not recognize cause of action based on economic duress; duress is recognized as means by which borrower may avoid obligations) (citing *Shields Enterprises, Inc. v. First Chicago Corp.*, 975 F.2d 1290, 1297; R.I.C.O. Bus. Disp. Guide (CCH) P 8088 (7th Cir. 1992)); *Federal Deposit Ins. Corp. v. Linn*, 671 F. Supp. 547, 556, 5 U.C.C. Rep. Serv. 2d 120 (N.D. Ill. 1987) (stating that economic duress is an affirmative defense to an action on a contract or note since a "contract executed under duress is voidable") (internal citation omitted); see also *Resolution Trust Corp. v. Ruggiero*, 977 1-11.2d 309, 314' (7th Cir. 1992) (holding that borrower could not avoid loan obligations as "mere hard bargaining is not enough" to give rise to affirmative defense of economic duress).

[4]See *Resolution Trust Corp. v. Ruggiero*, 977 F.2d 309, 314 (7th Cir. 1992) (holding that borrower could not avoid loan obligations because "the pressure applied must have been wrongful or unlawful; mere hard bargaining is not enough" to give rise to affirmative defense of economic duress); *In re Olde Prairie Block Owner LLC*, 441 B.R. 298, 302 (Bankr. N.D. Ill. 2010); see also *Rosas v. U.S. Small Business Admin.*, 964 F.2d 351, 357 (5th Cir. 1992) (holding that lender was not liable for duress based on "threats" to foreclose on borrower or to not fund a loan since both actions were within the lender's legal rights); *Federal Sav. and Loan Ins. Corp. v. Ziegler*, 680 F. Supp. 235, 237 (E.D. La. 1988) (holding that a threat to stop funding loan did not constitute duress since lender had the right to stop funding).

*Deposit Ins. Corp. v. Linn*,[5] the borrower asserted duress as an affirmative defense to the enforceability of a loan and guarantees which resulted from refinancing the borrower's original loans and guarantees. The borrower asserted that the notes were executed under duress because the bank conditioned the refinancing on the waiver of defenses to certain guarantees and threatened to place the borrowers in bankruptcy and initiate "wholesale litigation" on the borrowers' debts unless the borrowers agreed to the waiver. The court held that the "[b]anks were entitled to drive a hard bargain" and that the threatened actions did not constitute duress since "[t]hreatened bankruptcy is insufficient to create economic duress," the borrowers were represented by counsel, and "[t]hreatening to do what someone is legally entitled to do is not generally wrongful."[6]

### § 174:27 Tortious breach of duty of good faith

Every contract, including a contract to loan money, includes an implied duty of good faith.[1] In some jurisdictions, a lender may also be liable in tort for punitive damages based on a breach of this good-faith duty.[2]

In *Commercial Cotton Co. v. United California Bank*,[3] a California Appellate Court, based on the existence of a so-called "special relationship," upheld a verdict against a bank for tortious breach of good faith where the bank negligently paid a check containing unauthorized signatures and refused to credit the depositor's account based on what the jury found to be "spurious" defenses. Subsequent California cases,

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[5] *Federal Deposit Ins. Corp. v. Linn*, 671 F. Supp. 547, 5 U.C.C. Rep. Serv. 2d 120 (N.D. Ill. 1987).

[6] *Federal Deposit Ins. Corp. v. Linn*, 671 F. Supp. 547, 559-560, 5 U.C.C. Rep. Serv. 2d 120 (N.D. Ill. 1987).

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[1] *Alta Vista Properties, LLC v. Mauer Vision Center, PC*, 855 N.W.2d 722, 730-31 (Iowa 2014) (explaining the implied duty of good faith and fair dealing inheres in all contracts and cannot be disclaimed).

[2] See *In re USA Commercial Mortg. Co.*, 802 F. Supp. 2d 1147 (D. Nev. 2011) (upholding jury award for punitive damages for breach of good faith in tort in connection with servicing of loans).

[3] *Commercial Cotton Co. v. United California Bank*, 163 Cal. App. 3d 511, 209 Cal. Rptr. 551, 554, 40 U.C.C. Rep. Serv. 234, 55 A.L.R.4th 1017 (4th Dist. 1985).

however, have significantly restricted the application of this tort in the lender-borrower context.[4]

Lender liability for tortious breach of the duty of good faith also developed independently in *First Nat. Bank in Libby v. Twombly*,[5] in which the Montana Supreme Court stated:

> When the duty to exercise good faith is imposed by law rather than the contract itself. . . the breach of that duty is tortious. Therefore, punitive damages are recoverable if the Bank's conduct is sufficiently culpable.

The court later held that a bank was liable for tortious bad faith in accelerating the due date of a note after representing that it would refinance the note and without giving prior notice of acceleration to the borrower.[6] The Montana Supreme Court, however, subsequently confined liability for tortious bad faith to "special relationship contracts"[7] and restricted its application to lenders.[8]

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[4]See, e.g., *Rodriguez v. Plunkett*, 2003 WL 21915914 (Cal. App. 2d Dist. 2003), unpublished/noncitable, (recognizing that *Commercial Cotton* holding was explicitly overruled); *Copesky v. Superior Court*, 229 Cal. App. 3d 678, 280 Cal. Rptr. 338, 348, 14 U.C.C. Rep. Serv. 2d 525 (4th Dist. 1991) (stating that Commercial Cotton had been "misdirected" and holding that characterization of bank-depositor relationship as quasi-fiduciary is inappropriate and does not give rise to tort damages based on breach of the implied duty of good faith); *Price v. Wells Fargo Bank*, 213 Cal. App. 3d 465, 261 Cal. Rptr. 735, 740, (1st Dist. 1989), reh'g denied and opinion modified, (Sept. 21, 1989) (characterizing the *Commercial Cotton* case as "discredited" and holding that duty of good faith "does not impose any affirmative duty of moderation in the enforcement of legal rights"); see also *Mitsui Manufacturers Bank v. Superior Court*, 212 Cal. App. 3d 726, 260 Cal. Rptr. 793 (4th Dist. 1989) (holding that tortious bad faith did not apply where a lender refused to honor an oral commitment to renew a short-term loan since the bank was not a fiduciary of the borrower).

[5]*First Nat. Bank in Libby v. Twombly*, 213 Mont. 66, 689 P.2d 1226, 1230, 39 U.C.C. Rep. Serv. 1192 (1984).

[6]See *Tribby v. Northwestern Bank of Great Falls*, 217 Mont. 196, 704 13,2d 409 (1985) (holding bank liable for tortious breach of good faith in refusing to renew a loan and ceasing to make advances in retaliation for an unrelated lawsuit filed against the bank by the borrower).

[7]*Story v. City of Bozeman*, 242 Mont. 436, 791 P.2d 767, 776, 12 UGC, Rep. Serv. 2d 359 (1990) (limiting punitive damages for breach of the duty of good faith under Montana law to "special relationship contracts").

[8]See *Tresch v. Norwest Bank of Lewistown, N.A.*, 238 Mont, 511, 778 P.2d 874, 876 (1989) (holding that lender's refusal to advance funds did not breach any fiduciary duty owed to borrower); *Coles Dept. Store v. First Bank (N.A.)—Billings*, 240 Mont. 226, 783 P.2d 932, 936, 11 U.C.C. Rep. Serv. 2d 1074 (1989) (holding that lender's refusal to loan additional funds to borrower did not constitute a tortious breach of the duty of good faith since the lender did not act "arbitrarily or capriciously").

A lender is more likely to be liable in tort for breach of the good-faith duty if the breach was motivated by malice.[9]

Lender liability for tortious breach of good faith continues to develop although the trend appears to be away from imposing tort liability for breach of the duty of good faith.

### § 174:28 Intentional infliction of emotional distress

A lender can be liable for intentional infliction of emotional distress if (1) it engages in conduct that is extreme and outrageous, (2) the lender intends to cause or has reckless disregard for the probability of causing emotional distress, (3) the borrower suffers severe emotional distress, and (4) the lender's conduct was the actual and proximate cause of the emotional distress.[1] A corporation, however, cannot suffer severe emotional distress.[2]

Generally, a mere breach of contract is not considered extreme and outrageous conduct and will not give rise to a tort for intentional infliction of emotional distress.[3]

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[9]See, e.g., *Hernandez v. Bank*, 2016 WL 816746, *2 (D.N.J. 2016) (explaining that breach of good faith claim requires state of mind or malice-like elements and exercise of ordinary business discretion does not constitute malicious motive).

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[1]See Restatement Second, Torts § 46(1) (1965).

[2]See, e.g., *F.D.I.C. v. Hulsey*, 22 F.3d 1472, 1489, 23 U.C.C. Rep. Serv. 2d 596 (10th Cir. 1994) ("Since a corporation lacks the cognizant ability to experience emotions, a corporation cannot suffer emotional distress."); *Earth Scientists (Petro Services) Ltd. v. U.S. Fidelity & Guar. Co.*, 619 F. Supp. 1465, 1474 (D. Kan. 1985) (same); *HM Hotel Properties v. Peerless Indem. Ins. Co.*, 874 F. Supp. 2d 850, 853 (D. Ariz. 2012) (same regarding a limited liability company).

[3]See, e.g., *Standard Wire & Cable Co. v. AmeriTrust Corp.*, 697 F. Supp. 368, 371-72, R.I.C.O. Bus. Disp. Guide (CCH) P 7043 (C.D. Cal. 1988) (dismissing claim for distress resulting from borrower's bankruptcy and foreclosure on guarantors' homes where there were no "threats of physical harm [or] public harassment" and the plaintiffs' distress was not "severe" since it consisted of "headaches, insomnia, anxiety, [and] irritability"); see also *Southern Furniture Hardware, Inc. v. Branch Banking and Trust Co.*, 136 N.C. App. 695, 703, 526 S.E.2d 197 (2000) (holding that evidence that lender continued to discuss loan with borrower and imply that loan would be forthcoming soon even after internal approval of loan had been withdrawn failed to establish that lender's behavior "exceed[ed] all bounds usually tolerated by decent society."); *ARH Distributors, Inc. v. ITT Commercial Finance Corp.*, 1987 WL 17834 (N.D. Ill. 1987) (dismissing the borrower's claim for intentional infliction of emotional distress, stating "[t]his is hardly the stuff of outrage. . .[the lender] simply breached a contract.").

## § 174:29 Instrumentality

Instrumentality liability is the treatment of the lender as the agent, partner/joint venturer, or alter ego of the borrower. The result of imposition of instrumentality liability is that the claim of the lender against the borrower may be disallowed or treated as equity, or the lender may be held liable to other creditors of its borrowers.

## § 174:30 Instrumentality—Agency

A lender may be liable as a principal for the debtor's obligations if it assumes control over the borrower's business.[1] Section 14(0) of the Restatement (Second) of Agency, Comment (a) states:

> 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.

For example, in *A. Gay Jenson Farms Co. v. Cargill, Inc.*,[2] the Minnesota Supreme Court held that a lender was the principal of the borrower, a grain elevator, by the virtue of its control over the borrower's operations and, consequently, was liable as an undisclosed principal for debts of the borrower. The court noted that the lender was an active participant in the borrower's operations and financed the borrower "not to make money as a lender but, rather to establish a source of market

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[Section .30]

[1]Restatement Second, Agency § 14(0) (1957); but see *Tri-Meats, Inc. v. NASL Corp.*, 2001 WL 292621 (N.D. Ill. 2001) ("The leading authorities on this issue confirm that something akin to day-to-day management of the debtor's business is required before a lender can be held liable under an agency theory"); *Coastal Group, Inc. v. Westholme Partners*, 1998 WL 34233133 (D.N.J. 1998), aff'd, 229 F.3d 1137 (3d Cir. 2000) ("[C]ourts require a strong showing that the creditor assumed actual, participatory, total control of the debtor. Merely taking an active part in the management of the debtor corporation does not automatically constitute control, as used in the 'instrumentality' doctrine"); *Secon Service System, Inc. v. St. Joseph Bank and Trust Co.*, 855 F.2d 406, 417-418 (7th Cir. 1988) (holding that a lender's control of the debtor without more is not sufficient to create an agency).

[2]*A. Gay Jenson Farms Co. v. Cargill, Inc.*, 309 N.W.2d 285 (Minn. 1981).

grain for its business."[3] The factors noted by the court in determining that the lender controlled the borrower included constant recommendations to the borrower, drafts and forms supplied to the borrower on which the lender's name imprinted, right of first refusal to purchase the borrower's grain, right to enter the borrower's premises and conduct audits, and the lender's determination that the borrower needed "strong paternal guidance."[4]

### § 174:31 Instrumentality—Partner/joint venturer

A lender may be vicariously liable to a borrower's creditors if it is deemed to be a partner or joint venturer of the borrower. The essential elements for either a partnership or joint venture typically are: (1) a community of interest in the partnership/joint venture, (2) an agreement to share profits and losses, and (3) a mutual right of control or management of the enterprise.[1]

Fact situations giving rise to lender liability as a partner or joint venture of the borrower are rare.[2] For example, in *Connor v. Great Western Sav. & Loan Ass'n*,[3] the California Supreme Court held that, although a construction lender participated as both a buyer and seller of land in a real estate development project, it did not share a

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[3]*A. Gay Jenson Farms Co. v. Cargill, Inc.*, 309 N.W.2d 285, 292-93 (Minn. 1981).

[4]*A. Gay Jenson Farms Co. v. Cargill, Inc.*, 309 N.W.2d 285, 291 (Minn. 1981).

[Section .31]

[1]See, e.g., *Federal Deposit Ins. Corp. v. Claycomb*, 945 F.2d 853, 858 (5th Cir. 1991) (setting forth four requirements for establishing the existence of a joint venture: (1) a community of interest in the venture/partnership; (2) an agreement to share profits; (3) an agreement to share losses; and (4) a mutual right of control over management of the enterprise; see also *Sotheby's Financial Services, Inc. v. Baran*, 2003 WL 21756126, *7 (S.D. N.Y 2003), judgment aff'd, 107 Fed. Appx. 235 (2d Cir. 2004) (setting forth five requirements for establishing the existence of a joint venture: (1) two or more persons must enter into a specific agreement to carry on an enterprise for profit; (2) their agreement must evidence their intent to be joint venturers; (3) each must make a contribution of property, financing, skill, knowledge, or effort; (4) each must have some degree of joint control over the venture; and (5) there must be a provision for sharing of both profits and losses).

[2]See e.g., *Federal Deposit Ins. Corp. v. Claycomb*, 945 F.2d 853 (5th Cir. 1991) (holding that an express provision in notes that maker shall not be obligated to share in losses precluded finding of a partnership); *Secon Service System, Inc. v. St. Joseph Bank and Trust Co.*, 855 F.2d 406, 417 (7th Cir. 1988) (holding a lender does not have control over the borrower sufficient to establish a joint venture where the lender did not have an equal right to direct and govern the borrower's operations and the lender's sharing of profits and losses as an owner were contradicted by the lender's exercise of its security interest in the borrower's assets).

[3]*Connor v. Great Western Sav. & Loan Ass'n*, 69 Cal. 2d 850, 73 Cal. Rptr. 369, 375, 447 P.2d 609, 39 A.L.R.3d 224 (1968).

"community of interest" in the development since neither party had an interest in the payments received by the other. Similarly, in *Secon Service System, Inc. v. St. Joseph Bank and Trust Co.*,[4] the Seventh Circuit held that a lender did not have control over the borrower sufficient to establish a joint venture where the lender did not have an equal right to direct and govern the borrower's operations and the lender's sharing of profits and losses as an owner were contradicted by the lender's exercise of its security interest in the borrower's assets.

### § 174:32 Instrumentality—Alter ego

A lender may be liable for a corporate borrower's obligations if the borrowing "corporation is organized and operated as a mere tool or business conduit of another."[1] As noted by commentators, "[c]orporateness will not be recognized to produce unjust or undesirable consequences inconsistent with the purpose of the concept."[2]

Lender liability based on an alter ego theory, however, generally requires more than mere control over the borrower.[3] For example, in Valdes v. Leisure Resource Group, Inc.,[4] the Fifth Circuit stated that:

> In alter ego cases, the unfairness consists, not in fraud, but in the fact that the dominant shareholder or parent entity, because it controls the subservient company is the party responsible for creating the subservient's debts.[5]

The court then held that the lender did not own the borrower's stock based on its lien because it was not able to exercise the prerogatives of stock ownership such as electing members of the board of directors. The court also held that the lender did not have sufficient control over the borrower given the absence of actual stock ownership, even if the lender did approve each of the borrower's business expenditures, as it only had

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[4] *Secon Service System, Inc. v. St. Joseph Bank and Trust Co.*, 855 F.2d 406, 417 (7th Cir. 1988).

[Section .32]

[1] *Riquelme Valdes v. Leisure Resource Group, Inc.*, 810 F.2d 1345, 1353 (5th Cir. 1987).

[2] Henn & Alexander, Law of Corporations § 146 (3d ed. 1983).

[3] *Secon Service System, Inc. v. St. Joseph Bank and Trust Co.*, 855 F.2d 406, 415 (7th Cir. 1988) (holding that control alone is insufficient to disregard a corporation's separateness to reach shareholders for the benefit of the borrower's contract creditors).

[4] *Riquelme Valdes v. Leisure Resource Group, Inc.*, 810 F.2d 1345 (5th Cir. 1987).

[5] *Riquelme Valdes v. Leisure Resource Group, Inc.*, 810 F.2d 1345 (5th Cir. 1987).

a veto power, which did not usurp the borrower's power to make daily management decisions.[6]

## § 174:33 Conversion

A lender may be liable under conversion for the "intentional unauthorized and wrongful assumption of control, dominion, or ownership over the [borrower's] personal property by the [lender]."[1] A claim for conversion most often arises when a lender wrongfully repossesses collateral.[2] For example, in *Zimprich v. North Dakota Harvestore Systems, Inc.*,[3] the Supreme Court of North Dakota upheld a jury award of punitive damages based on conversion even though the borrower was behind in its payments under the loan. The court held that because there was some evidence that the lender agreed to defer repossession of the collateral, the jury could infer that the borrower had a continuing right to possess the property and, consequently, that the lender's repossession was wrongful.

## § 174:34 Prima facie tort

A lender may be liable for prima facie tort based on culpable actions taken without justification even though the lender is not liable under

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[6] *Riquelme Valdes v. Leisure Resource Group, Inc.*, 810 F.2d 1345, 1354-1355 (5th Cir. 1987); see also *Krivo Indus. Supply Co. v. National Distillers & Chemical Corp.*, 483 F.2d 1098, 1114 (5th Cir. 1973), (holding that influence arising from a lender's power and status as a major creditor did not make a lender labile to its borrower's creditors, since it did not exercise control in the actual debtor corporation).

[Section .33]

[1] *In re Alper-Richman Furs, Ltd.*, 147 B.R, 140, 161, 19 U.C.C, Rep. Serv. 2d 752 (Bankr. N.D. Ill. 1992) (holding that bank was not liable for conversion where the borrower voluntarily transferred the property to the lender pursuant to a settlement agreement even if such transfer was done by mistake).

[2] *Turner v. Firstar Bank, N.A.*, 363 Ill. App. 3d 1150, 300 Ill. Dec. 927, 845 N.E.2d 816 (5th Dist. 2006) (affirming award of punitive damages on conversion claim where lender's representative admitted that borrower's car never should have been repossessed, lender's payment processing system was unreliable and inaccurate, lender proceeded with collection actions even though it knew it could not verify accuracy of debt information, and lender knew that borrower disputed claim that she still owed money on loan); *Alaska Statebank v. Fairco*, 674 P.2d 288, 297, 37 U.C.C. Rep. Serv. 1782 (Alaska 1983) (affirming award of actual and punitive damages to a borrower whose collateral was repossessed without notice, even though the loan agreement authorized repossession without notice, where the lender waived. the right to strictly enforce the agreement by accepting late payments and negotiating a workout). But see *Bures v. First Nat. Bank, Port Lavaca*, 806 S.W.2d 935, 938, 15 U.C.C. Rep. Serv. 2d 296 (Tex. App. Corpus Christi 1991) (stating that "the mere filing of a security interest, without more, will not constitute conversion").

[3] *Zimprieh v. North Dakota Harvestore Systems, Inc.*, 461 N,W,2d 425, 430-431, 13 U.C.C. Rep. Serv. 2d 602 (N.D. 1990).

the preceding tort theories. Section 870 of the Restatement (Second) of Torts states:

> One who intentionally causes injury to another is subject to liability for that injury, if his conduct is generally culpable and not justifiable under the circumstances. This liability may be imposed although the actor's conduct does not come within a traditional category of tort liability.[1]

Typically, a lender will avoid liability to a borrower for prima facie tort by establishing that its actions were taken to protect a valid business interest.[2]

### § 174:35 Aiding and abetting liability

A lender may also be liable for the borrower's torts based on an aiding and abetting theory. The requirements to establish liability based on aiding and abetting are set forth in Restatement (Second) of Torts, Section 876, which provides:

> For harm resulting to a third person from the tortious conduct of another, one is subject to liability if he (a) does a tortious act in concert with the other or pursuant to a common design with him, or (b) knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself, or (c) gives substantial assistance to the other in accomplishing a tortious result and his own conduct, separately considered, constitutes a breach of duty to the third person.

The U.S. Supreme Court has explained, "[t]he Restatement of Torts, under a concert of action principle, accepts a doctrine with rough similarity to criminal aiding and abetting. An actor is liable for harm resulting to a third person from the tortious conduct of another 'if he. . .

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[Section .34]

[1]See also Restatement Second, Torts § 870, comments f to i (1977) (setting forth four factors to be considered in determining liability); *Maharaja Travel, Inc. v. Bank of India*, 1997 WL 154044 (S.D. N.Y. 1997) ("A cause of action for prima facie tort requires a plaintiff to show that disinterested malevolence was the sole motive for [lender's] conduct").

[2]See *Katz v. Travelers*, 241 F. Supp, 3d 397, 405 (E.D. N.Y. 2017) (avoiding liability where the plaintiff failed to establish an improper or wrongful purpose behind actions taken); see also *Rigby Corp. v. Boatmen's Bank and Trust Co.*, 713 S.W.2d 517, 544-45, 4 U.C.C. Rep. Serv. 2d 19 (Mo. Ct. App. W.D. 1986) (holding that even if the lender's acceleration of the note was a breach of contract and even if the lender intended to injure the borrower, the lender's actions were taken to protect its loan to the borrower, which was a valid business interest and sufficient justification for its actions to preclude liability based on prima facie tort).

knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other. . .' "[1] Under New York law, for example, there are three elements to establish a claim for aiding and abetting a breach of fiduciary duty.[2] The first element is "a breach by a fiduciary of obligations to another," of which the aider and abettor had "actual knowledge."[3] The second element is "that the defendant knowingly induced or participated in the breach"; and the third element is "that plaintiff suffered damage as a result of the breach."[4]

However, while aiding and abetting liability has been recognized in a number of states, the actual requirements may vary by state and some states have not recognized such a cause of action.[5]

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[Section .35]

[1] *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 182, 114 S. Ct. 1439, 128 L. Ed. 2d 119, Fed. Sec. L. Rep. (CCH) P 98178 (1994) (citing Restatement Second, Torts § 876(b) (1977)); see also W. Keeton, D. Dobbs, R. Keeton, & D. Owen, Prosser and Keeton on Law of Torts 322-324 (5th ed. 1984).

[2] See *In re Sharp Intern. Corp.*, 403 F.3d 43, 49-53, 44 Bankr. Ct. Dec. (CRR) 146 (2d Cir. 2005) (setting forth the elements of the tort of aiding and abetting in the context of bank's interactions with management).

[3] *In re Sharp Intern. Corp.*, 403 F.3d 43, 49-53, 44 Bankr. Ct. Dec. (CRR) 146 (2d Cir. 2005) quoting *Kaufman v. Cohen*, 307 A.D.2d 113, 125, 760 N.Y.S.2d 157, 169 (1st Dep't 2003) ("Although a plaintiff is not required to allege that the aider and abettor had an intent to harm, there must be an allegation that such defendant had actual knowledge of the breach of duty"); see also *Wechsler v. Bowman*, 285 N.Y. 284, 291, 34 N.E.2d 322, 326, 134 A.L.R. 1337 (1941) ("Any one who knowingly participates with a fiduciary in a breach of trust is liable for the full amount of the damage caused thereby to the cestuis que trust").

[4] *Kaufman v. Cohen*, 307 A.D.2d 113, 125, 760 N,Y.S.2d 157, 169 (1st Dep't 2003) (reciting elements of New York aiding and abetting a breach of fiduciary duty law); *S & K Sales Co. v. Nike, Inc.*, 816 F.2d 843, 847-48 (2d Cir. 1987) (same); *Whitney v. Citibank, N.A.*, 782 F.2d 1106, 1115 (2d Cir. 1986) (same).

[5] See, e.g., *Amato v. KPMG LLP*, 433 F. Supp. 2d 460, 473-74, 97 A.F.T.R.2d 2006-2889 (M.D. Pa. 2006), order vacated in part on reconsideration on other grounds, 98 A.F.T.R.2d 2006-6167, 2006 WL 2376246 (M.D. Pa. 2006) (collecting federal cases and following the "majority of Pennsylvania federal courts that have considered this issue and find[ing] that Pennsylvania law does not allow for claims of aiding and abetting fraud."); *Central Bank of Denver; N.A. v. First Interstate Bank of Denver; N.A.*, 511 U.S. 164, 182, 114 S. Ct. 1439, 128 L. Ed. 2d 119, Fed. Sec. L. Rep. (CCH) P 98178 (1994) (citing *F.D.I.C. v. S. Prawer & Co.*, 829 F. Supp. 463, 457 (D. Me. 1993)) ("In Maine, 'It is clear. . .that aiding and abetting liability did not exist under the common law, but was entirely a creature of statute.' "); *Meadow Ltd. Partnership v. Heritage Sav. and Loan Ass'n*, 639 F. Supp. 643, 653, R.I.C.O. Bus. Disp. Guide (CCH) P 6417 (E.D. Va. 1986) (noting that aiding and abetting tort, based on Restatement § 876 is "not expressly recognized by the state courts of the Commonwealth" of Virginia).

Where recognized, aiding and abetting liability may be alleged in connection with a breach of fiduciary duties owed to the borrower by an officer or director or with a borrower's fraud.[6]

## § 174:36 In pari delicto

The doctrine of in pari delicto provides that where two parties engage in tortious conduct, the parties cannot recover from each other for damages suffered as a result of such conduct; only injured third parties can recover for damages.[1] The term derives from the Latin phrase *in pari delicto potior est conditio defendantis*, which means "where the wrong of the one party equals that of the other, the defendant is in the stronger position."[2] The defense is based on (1) the equitable principle that a party should not profit from its own misconduct, and (2) the fundamental principle of agency law that the acts and knowledge of an agent are imputed to the principal where the agent is acting within the scope of its agency.[3]

In addition to the statutes discussed in this section, the Bankruptcy Code[4] may also expose a lender to potential liability with respect to its ability to obtain (or retain) repayment of its claims against the borrower. Because those topics are discussed elsewhere in this treatise, they are not dealt with here. It is worth noting, however, that such liability may

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[6]See, e.g., In re ENRON CORP., et al., Reorganized Debtors. Enron Corp,; Enron North America Corp.; Enron Natural Gas Marketing Corp.; Enron Broadband Services, Inc.; Enron Energy Services, Inc.; EES Service Holdings, Inc.; Enron International, Inc.; Enron Energy Services Operations, Inc.; ECT Merchant Investments Corp.; Enron Power Marketing, Inc.; and Atlantic Commercial Finance, Inc., Plaintiffs, v. Citigroup Inc.; Citibank, N.A.; Citigroup Global Markets, Inc.;, 2005 WL 331700 (Bankr. S.D. N.Y. 2005), Fourth Amended Complaint, dated January 10, 2005 (alleging a "multi-year scheme" between 10 banks and a "small group of senior officers and managers of Enron" to manipulate Enron's financial statements and misstate its financial condition).

[Section .36]

[1]See *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc.*, 267 F.3d 340, 354, 38 Bankr. Ct. Dec. (CRR) 147 (3d Cir. 2001) ("The doctrine of *in pari delicto* provides that a plaintiff may not assert a claim against a defendant if the plaintiff bears fault for the claim.").

[2]*Official Committee of Unsecured Creditors of Color Tile, Inc. v. Coopers & Lybrand, LLP*, 322 F.3d 147, 158, 40 Bankr. Ct. Dec. (CRR) 249, 54 Fed. R. Serv. 3d 1241 (2d Cir. 2003) (citing 34 Tex. Jur.3d, "Equity" § 31 (2002)).

[3]See, e.g., *In re Lehr Construction Corp.*, 551 B.R. 732, 738 (S.D. N.Y, 2016), aff'd, 666 Fed. Appx. 66 (2d Cir. 2016) ("Traditional agency principles play an important role in an in pari delicto analysis . . . namely, the acts of agents, and the knowledge they acquire while acting within the scope of their authority, are presumptively imputed to their principles.") (internal citation omitted).

[4]11 U.S.C.A. §§ 101 et seq.

arise from a lender's attempt to exercise control over the borrower, under theories of equitable subordination,[5] as well as under the evolving theory of equitable disallowance.[6] However, such liability may also arise, based not on the lender's conduct, but based on the impact of a particular transaction or repayment on the borrower's financial condition, such as under theories of preference[7] or constructive fraudulent transfers,[8] or based on the borrower's fraudulent intent, in the case of an intentionally fraudulent transfer.[9]

Several courts have held, in nonbankruptcy contexts, that the acts and knowledge of an entity's agents should not be imputed to an "innocent" trustee.[10] However, to date, such an approach has been generally rejected by courts in connection with bankruptcy

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[5]Norton Bankruptcy Law and Practice 3d § 67:3.

[6]See, e.g., *Adelphia Recovery Trust v. Bank of America, N.A.*, 390 B.R. 64 (S.D. N.Y. 2008), adhered to on reconsideration, 2008 WL 1959542 (S.D. N.Y. 2008) (noting that equitable disallowance theory may be available in certain circumstances and discussing legislative history of 11 U.S.C.A. § 510(c)(3)).

[7]Norton Bankruptcy Law and Practice 3d, chapter 66 (§§ 66:1 et seq.).

[8]Norton Bankruptcy Law and Practice 3d, chapters 63 (§§ 63:1 et seq.), 65 (§§ 65:1 et seq.), 67 (§§ 67:1 et seq.), 68 (§§ 68:1 et seq.), and 70 (§§ 70:1 et seq.).

[9]Norton Bankruptcy Law and Practice 3d § 67:3.

[10]See *Scholes v. Lehmann*, 56 F.3d 750, 754 (7th Cir. 1995); *F.D.I.C. v. O'Melveny & Myers*, 969 F.2d 744 (9th Cir. 1992), judgment rev'd on other grounds, 512 U.S. 79, 114 S. Ct. 2048, 129 L. Ed. 2d 67 (1994) and opinion adopted in part, 61 F.3d 17 (9th Cir. 1995) (explaining that "equitable defenses good against a bank do not carry over against the bank's receiver [because a] receiver, like a bankruptcy trustee and unlike a normal successor in interest, does not voluntarily step into the shoes of the bank; it is thrust into those shoes"); *Colonial BancGroup Inc. v. PricewaterhouseCoopers LLP*, 2017 WL 4175029, *5 (M.D. Ala. 2017), certification denied, 2017 WL 4176468 (M.D. Ala. 2017) (finding that "where the FDIC brings suit on behalf of innocent third parties who played no role in the [ ] fraud and where Colonial is in receivership and no longer exists (thus it will not benefit from any recovery by the FDIC), . . . the Alabama Supreme Court would decline to impute the misdeeds and/or negligence of Colonial employees to the FDIC").

proceedings.[11] As a result, the in pari delicto defense requires the court "to determine whether the debtor was complicit in the wrongdoing allegedly perpetuated by a third-party defendant."[12] If such misconduct is imputed to the debtor, the injury is deemed to be suffered by the debtor's creditors rather than the debtor itself, thereby precluding a bankruptcy trustee (or debtor in possession) from pursuing such a claim on behalf of the estate.[13] In such circumstances, "the cause of action is deemed to belong to the creditors qua creditors, and not to the estate or

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[11]See, e.g., *Official Committee of Unsecured Creditors of PSA, Inc. v. Edwards*, 437 F.3d 1145, 1151-53, 45 Bankr. Ct. Dec. (CRR) 279, Bankr. L. Rep. (CCH) P 80449, R.I.C.O. Bus. Disp. Guide (CCH) P 11025 (11th Cir. 2006) (holding that in pari delicto doctrine applied with equal force to bankruptcy trustee as to debtor outside bankruptcy, and if in pari delicto defense could have been raised in prebankruptcy suit by debtor, it can also be raised against the trustee of debtor's bankruptcy estate); *Grassmueck v. American Shorthorn Ass'n*, 402 F.3d 833, 837, 44 Bankr. Ct. Dec. (CRR) 135 (8th Cir. 2005) (holding that in pari delicto doctrine applied to bankruptcy trustee's suit against third party); *Knauer v. Jonathon Roberts Financial Group, Inc.*, 348 F.3d 280, 236 (7th Cir. 2003) (distinguishing *Scholes v. Lehmann*, 56 F.3d 750, 754 (7th Cir. 1995), relied upon by the Committee as applying to receivers bringing fraudulent conveyance claims on behalf of creditors and against recipients of wrongfully diverted funds and holding that the in pari delicto defense applies to a receiver's claims seeking tort damages against third parties alleged to be partly to blame for the occurrences); *In re Wedtech Securities Litigation*, 138 B.R. 5, 8 (S.D. N.Y. 1992) (holding that "[w]here . . . a trustee is asserting claims that belonged to the bankrupt company before its petition, not to the creditors, th[e] general rule [that the bankruptcy trustee is subject to all defenses] applies"). But see *In re Fuzion Technologies Group, Inc.*, 332 B.R. 225, 234 (Bankr. S.D. Fla. 2005) (holding that in pari delicto defense does not apply to a bankruptcy trustee as a matter of law). Moreover, Congress has considered legislation which would amend Code § 541(a) to provide that a trustee or debtor in possession shall not be subject to any defense based on the principles of in pari delicto, but such legislation has not been introduced in the House of Representatives or the Senate. Cf. Kathy Bazoian Phelps, Steven Rhodes, In Pali Delicto: Solutions to an Inequity Plaguing Bankruptcy Trustees and Innocent Creditors, 2015 Ann. Surv. of Bankr. Law 2 (2015) ("Compelling legal, equitable and policy reasons justify amending the bankruptcy code to make the *in pari delicto* defense inapplicable to trustee's claims under § 541.").

[12]*In re Hampton Hotel Investors, L.P.*, 289 B.R. 563, 574 (Bankr. S.D. N.Y. 2003) (citing *In re A.R. Baron & Co., Inc.*, 280 B.R. 794, 39 Bankr. Ct. Dec. (CRR) 237 (Bankr. S.D. N.Y. 2002)).

[13]*In re Hampton Hotel Investors, L.P.*, 289 B.R. 563, 577 (Bankr. S.D. N.Y. 2003) (holding that "the doctrine of in pant delicto [ ] has been applied to deny the trustee standing both in cases where the gravamen of the wrongful action was injury to creditors, depositors, or the public at large (and the injury to the debtor was only incidental), and in cases where the debtor was also a victim but where the debtor's management had been a participant in wrongful activity").

bankruptcy trustee, even though a bankruptcy trustee is seeking to recover on behalf of creditors."[14]

In New York, the courts have applied a similar bar to recovery, referred to as the "Wagoner Rule," which raises the defense of in pari delicto as a threshold challenge to standing.[15] In *Shearson Lehman Hutton, Inc. v. Wagoner*,[16] a bankruptcy trustee asserted a claim against a broker for churning the debtor's securities account, aiding and abetting a breach of fiduciary duty, and unduly influencing a sole shareholder in the making of bad trades that dissipated corporate funds. The sole shareholder knew of the bad investments and also actively managed them. The court held that "a claim against a third party for defrauding a corporation with the cooperation of management accrues to creditors, not to the guilty corporation," and therefore the bankruptcy trustee did not have standing to pursue such claims. Thus, while the *Wagoner* rule and the in pari delicto defense are substantively similar, successful assertion of the *Wagoner* rule provides that the plaintiff does not have standing to assert the cause of action, while successful

[14]*In re Hampton Hotel Investors, L.P.*, 289 B.R. 563, 577 (Bankr. S.D. N.Y. 2003) (internal citations omitted); see also *In re Stanwich Financial Services Corp.*, 488 B.R. 829, 834, 57 Bankr. Ct. Dec. (CRR) 224, Bankr. L. Rep. (CCH) P 82448 (D. Conn. 2013) (finding that "a claim against a third party for defrauding a corporation with the cooperation of management accrues to creditors, not to the guilty corporation") (citing *Shearson Lehman Hutton, Inc. v. Wagoner*, 944 E2d 114, 128, Bankr. L. Rep. (CCH) P 74290 (2d Cir. 1991)).

[15]See *Shearson Lehman Hutton, Inc. v. Wagoner*, 944 F.2d 114, Bankr. L. Rep. (CCH) P 74290 (2d Cir. 1991); see also *In re Bennett Funding Group, Inc.*, 336 F.3d 94, 41 Bankr. Ct. Dec. (CRR) 155, 50 Collier Bankr. Cas. 2d (MB) 1115, Bankr. L. Rep. (CCH) P 78889 (2d Cir. 2003) (applying the Wagoner rule); *Wight v. BankAmerica Corp.*, 219 F.3d 79, 46 Fed. R. Serv. 3d 1372 (2d Cir. 2000) (same); *In re Mediators, Inc.*, 105 F.3d 822, 30 Bankr. Ct. Dec. (CRR) 353, 37 Collier Bankr. Cas. 2d (MB) 723, Bankr. L. Rep. (CCH) P 77279 (2d Cir. 1997) (same); *Hirsch v. Arthur Andersen & Co.*, 72 F.3d 1085, 28 Bankr. Ct. Dec. (CRR) 494, Bankr. L. Rep. (CCH) P 76756 (2d Cir. 1995) (same); *In re PHS Group Inc.*, 581 B.R. 16, 65 Bankr. Ct. Dec. (CRR) 64 (Bankr. E.D. N.Y. 2018) (same); *In re Hampton Hotel Investors, L.P.*, 289 B.R. 563 (Bankr. S.D. N.Y. 2003) (same); *In re A.R. Baron & Co., Inc.*, 280 B.R. 794, 39 Bankr. Ct. Dec. (CRR) 237 (Bankr. S.D. N.Y. 2002) (same); *In re Granite Partners, L.P.*, 194 B.R. 318, 35 Collier Bankr. Cas. 2d (MB) 1139 (Bankr. S.D. N.Y. 1996), corrected, (Apr. 16, 1996) (same).

[16]*Shearson Lehman Hutton, Inc. v. Wagoner*, 944 F.2d 114, 120, Bankr. L. Rep. (CCH) P 74290 (2d Cir. 1991).

assertion of the in pari delicto defense provides that the defendant cannot be liable to the plaintiff for the alleged cause of action.[17]

Under the "adverse interest exception" to the in pari delicto defense, the tortious acts of an agent will not be imputed to the principal (i.e., the agent will not be deemed to have acted within the scope of its agency), and the defense of in pari delicto will not apply, where the agent is acting solely for its own benefit.[18] This exception is based on the principle that imputation is not justified where the agent is acting adverse to the principal.[19] Courts have generally held that this exception is narrow and

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[17]See *Global Crossing Estate Representative v. Winnick*, 2006 WL 2212776 (S.D. N.Y. 2006) ("While some courts have equated the *Wagoner* and 'in pari delicto' rules, others have characterized them as distinct. Other than the fact that the Wagoner rule is characterized as a standing rule, whereas 'in pari delicto' is an equitable defense, no Second Circuit case suggests a distinction between the two rules, and even the district and bankruptcy court cases that suggest that one exists do not, for the most part, explain what it might be. In any event, in this Court's view, the *Wagoner* and 'in pari delicto' rules are effectively identical") (internal citations omitted).

[18]See, e.g., *Belmont v. MB Inv. Partners, Inc.*, 708 F.3d 470, 495-97, Fed. Sec. L. Rep. (CCH) P 97297 (3d Cir. 2013) (applying adverse interest exception to in pari delicto defense); In re Investors Funding Corp. of New York Securities Litigation, 523 F. Supp. 533, Fed. Sec. L. Rep. (CCH) P 97696 (S.D. N.Y. 1980) (same); *In re Hampton Hotel Investors, L.P.*, 289 B.R. 563, 576 (Bankr. S.D. N.Y. 2003) ("Under [the adverse interest] exception, management misconduct will not be imputed to the corporation if the officer acted entirely in his own interest and adversely to the interest of the corporation.").

[19]See *Grassmueck v. American Shorthorn Ass'n*, 402 F.3d 833, 837, 44 Bankr. Ct. Dec. (CRR) 135 (8th Cir. 2005) (holding that "[t]he refusal to impute knowledge to the principal of an agent who is acting adversely to the principal is an acknowledgment that the usual legal fiction of complete agent-principal communication is unjustified where the agent is, acting adversely").

only applicable where the agent has "totally abandoned" the principal's interests.[20]

Moreover, the adverse interest exception is usually qualified or limited by the "sole actor rule."[21] Under this rule, where a "sole actor" clearly dominates the principal, or "where the principal and agent are one and the same," the acts and knowledge of the agent will nonetheless be imputed to the principal (i.e., the agent will be deemed to have acted within the scope of its agency), even if the agent is acting adverse to the principal.[22] This rule is based on the principle that where the principal and agent are effectively one and the same, "there is no reason to apply an adverse interest exception to the normal rules imputing the agent's acts and knowledge to the principal, because the party that should have

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[20]See *In re Fair Finance Company*, 834 F.3d 651, 679, 63 Bankr. Ct. Dec. (CRR) 2 (6th Cir. 2016) ("Even when an agent is defrauding his principal, unless the agent has totally abandoned the interests of the principal and is, acting entirely in his own, or another person's, interest, that agent is acting within the scope of his agency) (citing *In re CBI Holding Co., Inc.*, 311 B.R. 350, 373 (S.D. N.Y. 2004), on reh'g, 318 B.R. 761 (S.D. N.Y. 2004), aff'd in part, rev'd in part, 529 F.3d 432, 50 Bankr. Ct. Dec. (CRR) 23 (2d Cir. 2008) and aff'd in part, rev'd in part, 529 F.3d 432, 50 Bankr. Ct. Dec. (CRR) 23 (2d Cir. 2008)); *F.D.I.C. v. Ernst & Young*, 967 F.2d 166, 171 (5th Cir. 1992) (finding that corporate agent had acted on corporation's behalf "because by serving [the corporation], he served himself"); *In re Investors Funding Corp. of New York Securities Litigation*, 523 F. Supp. 533, Fed. Sec. L. Rep. (CCH) P 97696 (S.D. N.Y. 1980) ("This 'adverse interest' exception is not triggered . . . where the agent is also acting for the principal's benefit, even though the agent's primary interest is inimical to that of the principal.") (omitting citation); *In re CBI Holding Co., Inc.*, 311 B.R. 350, 369 (S.D. N.Y. 2004), on reh'g, 318 B.R. 761 (S.D. N.Y. 2004), aff'd in part, rev'd in part, 529 F.3d 432, 50 Bankr. Ct. Dec. (CRR) 23 (2d Cir. 2008) and aff'd in part, rev'd in part, 529 F.3d 432, 50 Bankr. Ct. Dec. (CRR) 23 (2d Cir. 2008) ("The adverse interest exception is a narrow one; for it to apply, the agent must have totally abandoned his principal's interest and be acting entirely for his own or another's purpose.") (internal citation omitted).

[21]See, e.g., *Grassmueck v. American Shorthorn Ass'n*, 402 F.3d 833, 838, 44 Bankr. Ct. Dec. (CRR) 135 (8th Cir. 2005) (applying sole actor exception to the adverse interest exception and finding that a general partner was the alter ego of the debtor partnership) (citing *In re Mediators, Inc.*, 105 F.3d 822, 827, 30 Bankr. Ct. Dec. (CRR) 353, 37 Collier Bankr. Casa 2d (MB) 723, Bankr. L. Rep. (CCH) P 77279 (2d Cir. 1997)).

[22]See *Grassmueck v. American Shorthorn Ass'n*, 402 F.3d 833, 838, 44 Bankr. Ct. Dec. (CRR) 135 (8th Cir. 2005); see also *In re Jack Greenberg, Inc.*, 212 B.R. 76, 86 (Bankr. E.D. Pa. 1997) (holding that under the sole actor exception, "if an agent is the sole actor or representative of the principal in the transaction to which notice is sought to be imputed, then that agent's wrongful conduct is imputable to the principal regardless of whether the agent's conduct was for the benefit of, or adverse to, the corporate interest").

been informed of the fraudulent conduct was the agent itself, albeit in its capacity as principal."[23]

The sole actor rule also applies in the context of a corporation that has multiple officers and directors.[24] The sole actor rule, in turn, is usually qualified or limited by the "innocent director exception." Under this exception, the sole actor rule is not applicable, and the acts and knowledge of an agent are not imputed to the principal, where at least one decision maker of the principal is innocent and could have stopped the wrongful conduct if aware of such conduct.[25] In *Wechsler*, the court found that the complaint failed to allege the "existence of an innocent member of [the debtor's] management who would have been able to prevent the fraud had he known about it," and therefore decided that the adverse interest exception precluded imputation under the *Wagoner*

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[23] *Grassmueck v. American Shorthorn Ass'n*, 402 F.3d 833, 838, 44 Bankr. Ct. Dec. (CRR) 135 (8th Cir. 2005) (internal citation omitted); see also *In re CBI Holding Co., Inc.*, 311 B.R. 350, 373 (S.D.N.Y. 2004), on reh'g, 318 B.R. 761 (S.D. N.Y. 2004), aff'd in part, rev'd in part, 529 F.3d 432, 50 Bankr. Ct. Dec. (CRR) 23 (2d Cir. 2008) and aff'd in part, rev'd in part, 529 F.3d 432, 50 Bankr. Ct. Dec. (CRR) 23 (2d Cir. 2008) ("When an agent has acted outside the scope of his agency, however, his acts will nevertheless be imputed to the principal 'where the principal and the agent are one and the same.' ") (internal citation omitted).

[24] See, e.g., *In re 1031 Tax Group, LLC*, 420 B.R. 178, 202, 52 Bankr. Ct. Dec. (CRR) 138 (Bankr. S.D. N.Y. 2009) (explaining that "[t]he sole actor rule has been applied when the manager was also the sole shareholder of the corporation or when all the corporation's management participated in the wrongdoing") (omitting citation); *Munroe v. Harriman*, 85 F.2d 493, 111 A.L.R. 657 (C.C.A. 2d Cir. 1936) (applying sole actor exception to bank president dominating bank's loan committee).

[25] See *In re Grumman Olson Industries, Inc.*, 329 B.R. 411, 425 (Bankr. S.D. N.Y. 2005) (explaining that "even if the wrongdoer is not a 'sole actor,' the adverse interest exception is still inapplicable unless there is at least one 'innocent' decision maker among management or the shareholders who could have stopped the fraud") (citing *In re Bennett Funding Group, Inc.*, 336 F.3d 94, 101, 41 Bankr. Ct. Dec. (CRR) 155, 50 Collier Bankr., Cas. 2d (MB) 1115, Bankr. L. Rep. (CCH) P 78889 (2d Cir. 2003)); *In re Fair Finance Company*, 2018 WL 1069443, *22 (Bankr. N.D. Ohio 2018) (finding that "when the innocent insiders possessed authority to stop the fraud, the 'sole actor rule' does not apply, because the culpable agents who had totally abandoned the interests of the principal, and thus were acting outside the scope of their agency, were not identical to the principal") (quoting *In re Fair Finance Company*, 834 F.3d 651, 679, 63 Bankr. Ct. Dec. (CRR) 2 (6th Cir. 2016) (internal citations omitted)); *In re CBI Holding Co., Inc.*, 311 B.R. 350 (S.D. N.Y. 2004), on reh'g, 318 B.R. 761 (S.D. N.Y. 2004), aff'd in part, rev'd in part, 529 F.3d 432, 50 Bankr. Ct. Dec. (CRR) 23 (2d Cir. 2008) and aff'd in part, rev'd in part, 529 F.3d 432, 50 Bankr. Ct. Dec. (CRR) 23 (2d Cir. 2008) ("The innocent insider exception . . . focuses not on whether culpable managers totally abandoned the company's interest, but rather on whether some part of management was innocent of the misconduct, unaware of it, and able to prevent it had the misconduct been known.").

rule.[26] The innocent insider exception to the *Wagoner* rule is not subject to a "would-a, could-a, should-a test" but requires a real, demonstrable agent who would have had the power to stop the fraud had the agent known of it.[27]

# III. STATUTORY LIABILITY

## A. INTRODUCTION

### § 174:37 Generally

This section focuses on federal statutes which are likely to be of concern during the workout or restructuring phase of a loan. During this phase, a lender may attempt to maximize its recovery or, conversely, minimize its losses by controlling the borrower's activity. By asserting this control, a lender may become liable for violating certain statutes or may become liable for the borrower's violation of certain statutes.

## B. COMPREHENSIVE ENVIRONMENTAL RESPONSE, COMPENSATION, LIABILITY ACT

### § 174:38 Generally

A lender may be strictly liable for the cost of cleaning up hazardous substances under the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA)[1] and comparable state laws. A lender may also have the value of its security interest in the borrower's property reduced due to the granting of "super liens," the allowance of

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[26] *Wechsler v. Squadron, Ellenoff, Plesent & Sheinfeld, L.L.P.*, 212 B.R. 34, 36 (S.D. N.Y. 1997); see also *Securities Investor Protection Corp. v. BDO Seidman, LLP*, 49 F. Supp. 2d 644 (S.D. N.Y. 1999), aff'd in part, question certified, 222 F.3d 63 (2d Cir. 2000), certified question accepted, 95 N.Y.2d 831, 712 N.Y.S.2d 910, 734 N.E.2d 1211 (2000) and certified question answered, 95 N.Y.2d 702, 723 N.Y.S.2d 750, 746 N.E.2d 1042 (2001) and judgment aff'd, 245 F.3d 174 (2d Cir. 2001) (finding that SIPA trustee lacked standing to sue, on behalf of firm, accountants alleged to have misrepresented condition of firm absent allegation that any member of firm's management was innocent of fraud and could have stopped it); *In re Walnut Leasing Co.*, 1999 WL 729267, n.9 (E.D. Pa. 1999) (holding that allegation in complaint that "there could never be a majority of disinterested" directors was sufficient to invoke the sole actor rule and imputation of acts of certain agents to corporation); *Lippe v. Bairnco Corp.*, 218 B.R. 294, 302, R.I.C.O. Bus. Disp. Guide (CCH) P 9460 (S.D. N.Y. 1998) (considering *Wechsler's* requirement of allegations of "innocent members of management" in the complaint but deciding that standing did not exist because the complaint alleged "sufficient unity between [the company] and [management] defendants to implicate [the company] in the alleged wrongdoing").

[27] *In re Bennett Funding Group, Inc.*, 336 F.3d 94, 41 Bankr. Ct. Dec. (CRR) 155, 50 Collier Bankr. Cas. 2d (MB) 1115, Bankr. L. Rep. (CCH) P 78889 (2d Cir. 2003).

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[1] 42 U.S.C.A. §§ 9601 et seq.

administrative expense status, or the invasion of its security to pay for the costs of cleaning up the hazardous substances.

A lender may be liable for the costs of cleaning up hazardous substances if the lender comes within one of the four classes of persons liable for such costs and does not come within the secured creditor exemption. The cleanup costs for which a lender could be liable include, inter alia, "all costs of removal or remedial action . . . [and] any other necessary costs of response incurred" in connection with a hazardous substance, and "damages for injury to, destruction of, or loss of natural resources." (collectively, the "cleanup costs").[2] Liability for these cleanup costs are imposed on the following four classes of persons:

> (1) the owner and operator of a vessel or a facility,
>
> (2) any person who at the time of disposal of any hazardous substance owned or operated any facility at which such hazardous substances were disposed of,
>
> (3) any person who . . . arranged for disposal or treatment . . . of hazardous substances owned or possessed by such person . . . at any facility or incineration vessel owned or operated by another party or entity and containing such hazardous substances, and
>
> (4) any person who accepts or accepted any hazardous substances for transport to disposal or treatment facilities, incineration vessels or sites selected by such person, from which there is a release, or a threatened release which causes the incurrence of response costs, of a hazardous substance.[3]

Secured lenders have been held liable for cleanup costs as either a present "owner and operator" of a facility[4] or as the owner or operator of a facility at the time the hazardous waste was disposed of.[5] Although liability as a present "owner and operator" was drafted in the

[2] 42 U.S.C.A. § 9607(a).

[3] 42 U.S.C.A. § 9607(a).

[4] 42 U.S.C.A. § 9607(a)(1).

[5] 42 U.S.C.A. § 9607(a)(2).

conjunctive, it has been construed in the disjunctive to provide liability as either the present owner or the present operator of the facility.[6]

## § 174:39 Secured creditor exemption

A lender may avoid liability as an owner or operator if it comes within the secured creditor exemption. This exemption is contained in CERCLA's definitions section, where the term "owner or operator" is defined, in relevant part, as follows:

> Such term does not include a person, who, without participating in the management of a vessel or facility, holds indicia of ownership primarily to protect his security interest in the vessel or facility.[1]

A secured creditor, consequently, may avoid liability under CERCLA unless it (1) participates in the management of the facility, or (2) holds indicia of ownership not primarily for the protection of its security interest.

In 1996, Congress enacted the Asset Conservation, Lender Liability and Deposit Insurance Protection Act (the "1996 Lender Liability Amendments").[2] The 1996 Lender Liability Amendments identified certain types of actions lenders could take without being found to have participated in the management of a facility or vessel and outlined certain steps that lenders could take to avoid liability when foreclosing on a property and protecting their security interest.

## § 174:40 Participating in the management

Prior to the enactment of the 1996 Lender Liability Amendments, courts varied regarding the degree of involvement a secured creditor was

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[6]See, e.g., *U.S. v. Fleet Factors Corp.*, 901 F.2d 1550, 1554 n.3, 20 Bankr. Ct. Dec. (CRR) 977, 31 Env't. Rep. Cas. (BNA) 1465, 20 Envtl. L. Rep. 20832 (11th Cir. 1990) (explaining that "[a]lthough the 'owner and operator' language of § 9607(a)(1) is in the conjunctive, we construe this language in the disjunctive in accordance with the legislative history of CERCLA and the persuasive interpretations of other federal courts") (omitting citations); *Asarco LLC v. Nl Industries, Inc.*, 106 F. Supp. 3d 1015, 1026 n.5, 81 Env't. Rep. Cas. (BNA) 1147 (E.D. Mo. 2015) ("Although § 9607(a)(1) is written in the conjunctive . . . has been interpreted in the disjunctive.") (omitting citations); *U.S. u. Maryland Bank & Trust Co.*, 632 F. Supp. 573, 577, 24 Env't. Rep. Gas. (BNA) 1193, 16 Envtl. L. Rep. 20557 (D. Md. 1986) (finding that "[n]otwithstanding the language 'the owner and operator,' a party need not be both an owner and operator to incur liability under [42 U.S.C.A. § 9607(a)(1)]).

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[1]42 U.S.C.A. § 9601(20)(A).

[2]Pub. L. No. 104-208, 110 Stat. 3009-462 (1996).

permitted before it lost the benefit of the secured creditor exemption under CERCLA. Initially, this exemption was interpreted to preclude liability unless the secured creditor was participating in the day-to-day management of the facility. In *U.S. v. Mirabile*,[1] the initial case addressing this issue, the court stated that "[m]ere financial ability to control waste disposal practices . . . is not . . . sufficient for the imposition of liability"[2] and that "before a secured creditor . . . may be held liable, it must, at a minimum, participate in the day-to-day operational aspects of the site."[3]

The *Mirabile* court then held that the secured creditor was not an "owner or operator" of the facility because it "merely foreclosed on the property after all operations had ceased" and, consequently, was not liable under CERCLA because it had not engaged in operational control of the facility.[4]

Subsequently, in *U.S. v. Fleet Factors Corp.*,[5] the Eleventh Circuit restricted the exemption and rejected the day-to-day management analysis in favor of a "capacity to influence" standard. In *Fleet Factors*, the court stated that a secured creditor may be liable:

> by participating in the financial management of a facility to a degree indicating a capacity to influence the corporation's treatment of hazardous wastes. It is not necessary for the secured creditor actually to involve itself in the day-to-day operations of the facility in order to be liable . . . . Nor is it necessary for the secured creditor to participate in management decisions relating to hazardous waste. Rather, a secured creditor will be liable if its involvement with the management of the facility is sufficiently broad to support the inference that it could affect hazardous waste 'disposal decisions if it so chose.[6]

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[1] *U.S. v. Mirabile*, 15 Envtl, L. Rep. 20992, 15 Envtl. L. Rep. 20994, 1985 WL 97 (E.D. Pa. 1985) (mem.).

[2] *U.S. v. Mirabile*, 15 Envtl. L. Rep. 20992, 15 Envtl. L. Rep. 20994, 1985 WL 97 (E.D. Pa. 1985).

[3] *U.S. v. Mirabile*, 15 Envtl. L. Rep. 20992, 15 Envtl. L. Rep. 20994, 1985 WL 97 (E.D. Pa. 1986).

[4] *U.S. v. Mirabile*, 15 Envtl. L. Rep. 20992, 15 Envtl. L. Rep, 20994, 1985 WL 97 (E.D. Pa. 1985).

[5] *U.S. v. Fleet Factors Corp.*, 901 F.2d 1550, 20 Bankr. Ct. Dec. (CRR) 977, 31 Env't. Rep. Cap. (BNA) 1465, 20 Envtl. L. Rep. 20832 (11th Cir. 1990).

[6] *U.S. v. Fleet Factors Corp.*, 901 F.2d 1550, 1557-58, 20 Bankr. Ct. Dec, (CRR) 977, 31 Env't. Rep. Cas. (BNA) 1465, 20 Envtl. L. Rep. 20832 (11th Cir. 1990).

The court then concluded that the secured creditor was an "owner or operator" and liable under CERCLA because the creditor's "involvement in the financial management of the facility was pervasive, if not complete."[7]

Subsequent to the decision in *Fleet Factors*, the Ninth Circuit and the Environmental Protection Agency ("EPA") rejected the "control to influence" standard and adopted the day-to-day management analysis. In *In re Bergsoe Metal Corp.*,[8] the Ninth Circuit dismissed a claim against a secured creditor and stated that "whatever the precise parameters of 'participation,' there must be some actual management of the facility before a secured creditor will fall outside the exception." Similarly, the EPA promulgated regulations interpreting the "owner or operator" clause in the secured creditor exemption.[9] The EPA regulations provide that:

> Participation in the management of a facility means. . . actual participation in the management or operational affairs of the vessel or facility by the holder, and does not include the mere capacity to influence or ability to influence, or the unexercised right to control facility operations.[10]

The EPA regulations also provide that a creditor is not participating in management-based actions taken at the inception of the loan or to police its security interests or based on work out activities engaged in prior to foreclosure.[11] The EPA regulations do provide, however, that a creditor is participating in management if it has undertaken or assumed responsibility for the borrower's handling of hazardous substances or disposal practices or substantially all of the operational aspects of the borrower other than environment compliance.[12]

The 1996 Lender Liability Amendments largely codified the EPA regulatory provisions regarding the "participate in management" criteria, and unequivocally rejected the *Fleet Factors* standards, by providing that participating in management "does not include merely having the capacity to influence, or the unexercised right to control,

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[7] *U.S. v. Fleet Factors Corp.*, 901 F.2d 1550, 1559, 20 Bankr. Ct. Dec. (CRR) 977, 31 Env't. Rep. Cas. (BNA) 1465, 20 Envtl. L. Rep. 20832 (11th Cir. 1990).

[8] *In re Bergsoe Metal Corp.*, 910 F.2d 668, 672, 31 Env't. Rep. Cas. (BNA) 1785, 20 Envtl. L. Rep. 21229 (9th Cir. 1990) (emphasis omitted).

[9] 40 C.F.R. § 300.1100 (promulgated April 29, 1992).

[10] 40 C.F.R. § 300.1100(c)(1).

[11] 40 C.F.R. § 300.1100(c)(2).

[12] 40 C.F.R. § 300.1100(c)(1).

vessel or facility operations" but requires "actually participating in management or operational affairs of a vessel; or facility."[13]

The 1996 Lender Liability Amendments further provided that a lender who holds "indicia of ownership primarily to protect a security interest. . . shall be considered to participate in management" when the borrower is in possession of the facility or vessel, only if the lender:

> (I) exercises decision-making control over the environmental compliance related to the vessel or facility, such that the person has undertaken responsibility for the hazardous substance handling or disposal practices related to the vessel or facility; or
>
> (II) exercises control at a level comparable to that of a manager of the vessel or facility, such that the person has assumed or manifested responsibility:
>
> > (aa) for the overall management of the vessel or facility encompassing day-to-day decision making with respect to environmental compliance; or
> >
> > (bb) over all or substantially all of the operational functions (as distinguished from financial or administrative functions) of the vessel or facility other than the function of environmental compliance.[14]

The 1996 Lender Liability Amendments also include the following nine permitted activities which do not constitute "participation in management":

> (I) holding a security interest or abandoning or releasing a security interest;
>
> (II) including in the terms of an extension of credit, or in a contract or security agreement relating to the extension, a covenant, warranty, or other term or condition that relates to environmental compliance;
>
> (III) monitoring or enforcing the terms and conditions of the extension of credit or security interest;
>
> (IV) monitoring or undertaking 1 or more inspections of the vessel or facility;
>
> (V) requiring a response action or other lawful means of addressing the release or threatened release of a hazardous substance in connection with the vessel or facility prior to, during, or on the expiration of the term of the extension of credit;

[13] 42 U.S.C.A. § 9601(20)(F)(i).

[14] 42 U.S.C.A. § 9601(20)(F)(ii).

(VI) providing financial or other advice or counseling in an effort to mitigate, prevent, or cure default or diminution in the value of the vessel or facility;

(VII) restructuring, renegotiating, or otherwise agreeing to alter the terms and conditions of the extension of credit, or security interest, exercising forbearance;

(VIII) exercising other remedies that may be available under applicable law for the breach of a term or condition of the extension of credit or security agreement, or

(IX) conducting a response action under § 9607(d) of this title or under the direction of an on-scene coordinator appointed under the National Contingency Plan.[15]

Given the long list of criteria under the 1996 Lender Liability Amendments, courts scrutinize the relationship between lenders and borrowers to decide whether the lender participated in the management of a company.[16] In *XDP, Inc. v. Watumull Properties Corp.*,[17] the court found that a question of fact exists as to whether a lender controlled and managed a contaminated facility's operations and denied the lender's motion for summary judgment. In that case, the lender financed the acquisition of a manufacturing business and secured the loan with a mortgage and liens on the facility and equipment. After the borrower defaulted, the lender did not foreclose, but instead took title to the facility through an asset purchase agreement and transferred the assets to the lender's newly formed subsidiary. In its decision, the court noted that the sole director, president, and secretary of the subsidiary that purchased the borrower, was also the manager of the lender's branch office in Portland. In addition, the lender's subsidiary that managed the borrower did not have separate offices, accountants, or attorneys and any such functions were conducted by the bank. As a result, the court held that there was sufficient evidence in the record for a reasonable finder of fact to conclude that the lender was actively involved in the

[15] 42 U.S.C.A. § 9601(20)(F)(iv).

[16] See, e.g., *United States v. Puerto Rico Industrial Development Company*, 287 F. Supp, 3d 133, 150, 85 Env't. Rep. Cas. (BNA) 2215 (D.P.R. 2017) (explaining that "[f]undamentally, two inquiries govern the secured creditor exemption analysis: (1) whether [the lender] 'holds indicia of ownership primarily to protect its security interest in the [property]" and (2) whether [lender] participated 'in the management of the [property]' ") (omitting citation); *Georgia-Pacific Consumer Products LP v. NCR Corporation*, 2013 WL 12075738, *5 (W.D. Mich. 2013) (holding that "the secured creditor exemption, by its original terms, implicates a fact-intensive inquiry of a party's primary intentions," and finding in that case that "[t]he necessary line-drawing will likely focus on the question whether [the lender] held indicia of ownership 'primarily to protect [its] security interest' ") (omitting citation).

[17] *XDP, Inc. v. Watumull Properties Corp.*, 2004 WL 1103023 (D. Or. 2004).

management of ‘the facility and that the lender incorporated several subsidiaries as sham corporations in order to shield itself from liability.

Conversely, in *U.S. v. Pesses*,[18] a magistrate found that a lender did not participate in the management of the company even though the lender failed to sell or release the property for 15 years. In that case, the lender listed the property for sale expeditiously, but radioactive materials were found on the site. Although prospective lessees insisted materials be removed before they leased the property, the lender refused because the clean-up costs were greater than the balance of the loan and the value of the property. The lender also sought purchasers for the site, none of which were able to find financing. Under these circumstances, the magistrate found that the lender was exempt from owner-operator liability.

### § 174:41 Indicia of ownership to protect security interest

Prior to the 1996 Lender Liability Amendments, courts differed on whether the lender becomes an “owner or operator” upon foreclosure for purposes of determining lender liability for cleanup costs under CERCLA. The 1996 Lender Liability Amendments added a section which excluded lenders not involved in management, even if the lenders initiated foreclosure proceedings. The new 42 U.S.C.A. § 9601(20)(E) states that the term “owner or operator” does not include a lender that did not participate in the management of a facility or vessel prior to foreclosure, notwithstanding that the lender:

> (I) forecloses on the vessel or facility; and
>
> (II) after foreclosure, sells, re-leases (in the case of a lease finance transaction), or liquidates the vessel or facility, maintains business activities, winds up operations, undertakes a response action . . . or takes any other measure to preserve, protect, or prepare the vessel or facility prior to sale or disposition, if the person seeks to sell, release (in the case of a lease finance transaction), or otherwise divest the person of the vessel or facility at the earliest practicable, commercially reasonable time, on commercially reasonable terms, taking into account market conditions and legal and regulatory requirements.

The test gives courts room to determine what constitutes “commercially reasonable time” and “commercially reasonable terms,” in contrast to the EPA regulations promulgated in 1992, which contained the bright-line test that a lender lost its exemption in certain

[18] *U.S. v. Pesses*, 1998 WL 937235 (W.D. Pa. 1998).

situations if it refused a bona fide offer or failed to list the property for sale with a broker within 12 months following foreclosure.

### § 174:42 Innocent purchaser defense

In addition to the secured creditor exemption from liability for cleanup costs, a lender may also avoid CERCLA liability if damages from the hazardous substances were caused solely by (1) an act of God, (2) an act of war, (3) an act or omission by a third party other than an employee or agent of the defendant, or than one whose act or omission occurs in connection with a "contractual relationship" with the defendant, existing directly or indirectly, if the defendant (a) exercised due care with respect to the hazardous substance and (b) took precautions against foreseeable acts or omissions of such third party and the consequences that could foreseeably result from such acts or omissions, or (4) any combination of the foregoing.[1]

"Contractual relationship" is defined to include "land contracts, deeds, easements, leases, or instruments transferring title or possession" unless, inter alia, "[a] t the time the defendant acquired the facility the defendant did not know and had no reason to know that any hazardous substance which is the subject of the release or threatened release was disposed of on, in, or at the facility."[2] The clause "no reason to know" is further defined to require that the defendant must have carried out, on or before the time of acquisition, "all appropriate inquiries. . . into the previous ownership and uses of the facility in accordance with generally accepted good commercial and customary standards and practices."[3]

The viability of the innocent purchaser defense has been tested by secured creditors seeking to evade liability under CERCLA, but courts have stated that the appropriateness of the buyer's inquiry for the

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[1] 42 U.S.C.A. § 9607(b).

[2] 42 U.S.C.A. § 9601(35)(A).

[3] 42 U.S.C.A. § 9601(35)(B)(i).

exception to apply is fact-intensive and depends on the totality of the circumstances.[4]

The EPA, however, promulgated certain rules with respect to satisfying the requirement of conducting all appropriate inquiries for property purchased on or after May 31, 1997.[5] In examining whether the defendant's inquiry was sufficient to support the defense, with respect to property purchased prior to 1997, courts must consider: (i) any specialized knowledge or experience on the part of the defendant, (ii) the price of the property in relation to the value if uncontaminated, (iii) commonly known or reasonably ascertainable information about the property, (iv) obviousness of presence or likely presence of contamination at the property and, (v) ability to detect such contamination on appropriate inspection.[6]

### § 174:43 Aiding and abetting liability

At least one court has held that a lender can be liable for the borrower's environmental liabilities based on an aiding and abetting theory. In *O'Neil v. Q.L.C.R.I., Inc.*,[1] the court rejected the lender's argument that only the borrower, as the principal polluter, could be liable under the Federal Water Pollution Control Act. The court held that the plaintiff "alleged sufficient involvement and possible control on the part of [the lender] to present a viable claim of aiding and abetting."[2] However, this holding does not seem to have been followed by other courts.

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[4]See *U.S. v. 150 Acres of Land*, 204 F.3d 698, 707, 49 Env't. Rep. Cas. (BNA) 1961, 30 Envtl. L. Rep. 20300, 2000 FED App. 0033P (6th Cir. 2000) (explaining that "the particular inquiry that is necessary under the statutory definition is clearly dependent on the totality of the circumstances"); see also H.R.Rep. No. 1016, 96th Cong. 2d Sess., pt. 1, at 34 (1980), reprinted in 1980 U.S.C.C.A.N. 6119, 6137 ("[T]he defendant must demonstrate that he took all precautions with respect to the particular waste that a similarly situated reasonable and prudent person would have taken in light of all relevant facts and circumstances.").

[5]40 C.F.R. § 300.312.1 (promulgated May 9, 2003).

[6]42 U.S.C.A. § 9601(35)(B)(iv).

[Section .43]

[1]*O'Neil v. Q.L.C.R.I., Inc.*, 750 F. Supp. 551, 555, 32 Env't. Rep. Cas. (BNA) 1661, 21 Envtl. L. Rep. 20291 (D.R.I, 1990).

[2]*O'Neil v. Q.L.C.R.I., Inc.*, 750 F. Supp. 551, 555, 32 Env't. Rep. Cas. (BNA) 1661, 21 Envtl. L. Rep. 20291 (D.R.I, 1990).

### C. RACKETEER INFLUENCED AND CORRUPT ORGANIZATIONS ACT

#### § 174:44 Generally

A lender may be liable to the borrower for treble damages if it engages in a pattern of racketeering under the Racketeer Influenced and Corrupt Organizations Act ("RICO").[1] RICO § 1964(c) provides, in relevant part:

> Any person injured in his business or property by reason of a violation of § 1962 of this chapter may sue therefore in any appropriate United States district court and shall recover threefold the damages he sustains and the cost of the suit, including a reasonable attorney's fee[.][2]

The "by reason of clause in § 1964(c) has been interpreted to require more than a "but for" relationship between the violation and the injury.[3] The plaintiff must show that the defendant's violation was the "proximate cause" of the plaintiff's injury. For example, in *P.M.F. Services, Inc. v. Grady*,[4] the court dismissed a complaint alleging that the lender received interest and services fees from the borrower's account, but failing to allege that the lender's use of these fees to fund its own operation was the proximate cause of the borrower's injury.

In addition, several circuits have required that, for causation in fact to exist where the alleged predicate acts are based on misrepresentations, the plaintiff must have relied on such misrepresentations. For instance, the Second Circuit held that for causation in fact to exist in a civil RICO action predicated on any act of fraud, a "plaintiff must establish 'reasonable reliance' on the defendant's purported misrepresentations or omissions," regardless of the type of

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[Section .44]

[1] 18 U.S.C.A, §§ 1961 et seq.

[2] 18 U.S.C.A. § 1964(c).

[3] See *Holmes v. Securities Investor Protection Corp.*, 503 U.S. 258, 112 S. Ct. 1311, 1316-18, 117 L. Ed. 2d 532, Fed. Sec. L. Rep. (CCH) ¶ 96555, R.I.C.O, Bus. Disp. Guide (CCH) P 7968 (1992) ("Thus, we held that a plaintiffs right to sue under § 4 required a showing that the defendant's violation not only was a 'but for' cause of his injury, but was the proximate cause as well."); see also *Ray v. Spirit Airlines, Inc.* 836 F.3d 1340, 1349, R,I.C.O. Bus. Disp. Guide (CCH) P 12766 (11thCir, 2016) (finding that "pleading a civil RICO claim requires that plaintiffs plead facts sufficient to give rise to a reasonable inference that the claimed racketing activity. . . Avas the but-for and proximate cause of the plaintiffs' injuries").

[4] *P.M.F. Services, Inc. v. Grady*, 681 F. Supp. 549, 556 (N.D. Ill. 1988).

fraud that is the predicate.[5] Subsequently, in 2008, the Supreme Court narrowed the Second Circuit's ruling by holding that a plaintiff alleging violation of Section 1962 for racketeering conducted through mail or wire fraud without proving reliance on such fraud.[6]

RICO § 1962 makes it unlawful for any person to: (1) acquire or maintain, directly or indirectly, an interest in or control of any enterprise which is engaged in, or the activities of which affect, interstate or foreign commerce, through a pattern of racketeering activity or through collection of an unlawful debt,[7] (2) conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs through a pattern of racketeering activity or the collection of unlawful debt,[8] (3) use or invest income derived from a pattern of racketeering activity or through collection of an unlawful debt to acquire an interest in or to establish the operation of an enterprise which is engaged in, or the activities of which affect, interstate or foreign commerce,[9] or (4) conspire to engage in any of the preceding activities.[10] Additionally, a lender may be liable for aiding and abetting if the lender,

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[5] *Bank of China, New York Branch v. NBM LLC*, 359 F.3d 171, 178, R.I.C.O. Bus. Disp. Guide (CCH) P 10628, 63 Fed. R. Evid. Serv. 893 (2d Cir. 2004), for additional opinion, see, 89 Fed. Appx. 751, R.I.C.O. Bus. Disp. Guide (CCH) P 10632 (2d Cir. 2004) (holding that it was reversible error for jury charge not to require the plaintiff in RICO action to establish reliance on the defendant's purported misrepresentation); see also *Cummins v. Select Portfolio Servicing, Inc.*, 2016 WL 11395016, *4 (E.D. N.Y. 2016), report and recommendation adopted, 2016 WL 4766237 (E.D. N.Y. 2016) ("To plausibly allege an injury from reliance on fraudulent documents a plaintiff 'must establish reasonable reliance on defendants' purported misrepresentation or omissions.' ") (quoting *Bank of China, New York Branch v. NBM LLC*, 359 F.3d 171, 178, R.I.C.O. Bus. Disp. Guide (CCH) P 10628, 63 Fed. R. Evid. Serv. 893 (2d Cir. 2004), for additional opinion, see, 89 Fed. Appx. 751, R.I.C.O. Bus. Disp. Guide (CCH) P 10632 (2d Cir. 2004)).

[6] *Bridge v. Phoenix Bond & Indem. Co.*, 553 U.S. 639, 658, 128 S. Ct. 2131, 170 L. Ed. 2d 1012, R.I.C.O. Bus. Disp. Guide (CCH) P 11500 (2008).

[7] 18 U.S.C.A, § 1962(b).

[8] 18 U.S.C.A. § 1962(c).

[9] 18 U.S.C.A. § 1962(a).

[10] 18 U.S.C.A, § 1962(d).

"with the requisite knowledge, substantially assisted" the borrower in conducting racketeering activities.[11]

## § 174:45 Pattern of racketeering activity

Racketeering activity, frequently referred to as "predicate acts," is defined to include a long list of state and federal crimes, including mail fraud, wire fraud, and fraud in connection with a bankruptcy case.[1] A person commits mail and wire fraud by using the mail and wire services for the purpose of executing a scheme or artifice to defraud.[2] A person commits a bankruptcy crime by "knowingly and fraudulently" engaging in certain prohibited acts either "in contemplation of or during a bankruptcy case.[3]

A "pattern of racketeering activity" requires at least two acts of racketeering activity within a 10-year period.[4] However, as noted by the Supreme Court in *Sedima S. P. R. L. v. Imrex Co.*,[5] "while two acts are necessary, they may not be sufficient." Subsequently, in *H.J., Inc. v.*

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[11]See, e.g., *Odesser v. Continental Bank*, 676 F. Supp. 1305, 1313-1314 (E.D. Pa. 1987) (holding complaint sufficient to state action against lender for aiding and abetting primary violator by mailing copy of fraudulent board resolution to third parties with the knowledge that it was invalid and in transferring funds based on the fraudulent resolution); *Blue Line Coal Co., Inc. v. Equibank*, 1989 WL 63203, *6 (E.D. Pa. 1989) (explaining that lender can be liable for aiding and abetting under § 1962 to the extent that it was part of an enterprise consisting of an association in fact); but cf. *Pennsylvania Ass'n of Edwards Heirs v. Rightenour*, 235 F.3d 839, 844, R.I.C.O. Bus. Disp. Guide (CCH) P 9994 (3d Cir. 2000) (holding that "in the absence of statutory authorization, there is no presumption in favor of recognizing a civil aiding and abetting [RICO] claim").

**[Section .45]**

[1]See 18 U.S.C.A. § 1961(1).

[2]18 U.S.C.A. §§ 1341 (mail fraud), 1343 (wire fraud).

[3]See 18 U.S.C.A. § 152.

[4]18 U.S.C.A. § 1961(5); see also *LaVay Corp. v. Dominion Federal Sav. & Loan Ass'n*, 830 F.2d 522, 529, R.I.C.O. Bus. Disp. Guide (CCH) P 6749, 9 Fed. R. Serv. 3d 597 (4th Cir. 1987) ("A RICO claim may not be based on a single noncriminal breach of fiduciary duty, for under no circumstances could a breach of fiduciary duty constitute a pattern of racketeering activity."); *Watson v. Faris*, 139 F. Supp. 3d 456, 461 (D.D.C. 2015) (finding that where plaintiff's "sole RICO allegation . . . refers to the single act of foreclosure on his personal residence . . . there is plainly no 'pattern' of racketeering activity, [and] no sufficient RICO claim has been articulated") (citing cases).

[5]*Sedima, S.P.R.L. v. Imrex Co., Inc.*, 473 U.S. 479, 496 n.14, 105 S. Ct, 3275, 87 L. Ed. 2d 346, Fed. Sec. L. Rep. (CCH) P 92086, R.I.C.O. Bus. Disp. Guide (CCH) P 6100, 1985-2 Trade Cas. (CCH) ¶ 66666 (1985) (explaining that "[t]he legislative history supports the view that two isolated acts of racketeering activity do not constitute a pattern" and citing Senate Report for the proposition that "[t]he target of [RICO] is thus not sporadic activity. . . .[but] the factor of continuity plus relationship which combines to produce a pattern' ") (quoting S. Rep. No. 91-617, p. 158 (1969)).

*Northwestern Bell Telephone Co.,*[6] the Supreme Court explained that a pattern of racketeering activity includes both a "relatedness" and a "continuity" component. The relatedness component may be satisfied by showing that the illegal acts relate to the same transaction.[7] The continuity component can be proven in a variety of ways but may be satisfied by showing multiple criminal schemes or that the illegal acts wore part of the person's regular way of doing business.[8] For example, in *Edwards v. First Nat. Bank, Bartlesville, Oklahoma*,[9] the Tenth Circuit held that the relatedness component was not satisfied by statements made to different borrowers by different employees of the

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[6]*H.J. Inc. v. Northwestern Bell Telephone Co.*, 492 U.S. 229, 239, 109 S. Ct. 2893, 106 L. Ed. 2d 195, R.I.C.O. Bus. Disp. Guide (CCH) P 7237, 103 Pub. Util. Rep. 4th (PUR) 513 (1989) (finding that "[t]he term pattern itself requires the showing of a relationship between the predicates and of the threat of continuing activity. It is this factor of continuity plus relationship which combines to produce a pattern") (quoting 116 Cong. Rec., 18940 (1970) (statement of Sen. McClellan)) (internal citation and quotation marks omitted).

[7]See *H.J. Inc. v. Northwestern Bell Telephone Co.*, 492 U.S. 229, 240, 109 S. Ct. 2893, 106 L. Ed. 2d 195, R.I.C.O. Bus. Disp. Guide (CCH) P 7237, 103 Pub. Util. Rep. 4th (PUR) 513 (1989) (explaining that, under 18 U.S.C.A. § 3575(e), "criminal conduct forms a pattern if it embraces criminal acts that have the same or similar purposes, results, participants, victims, or methods of commissions, or otherwise are interrelated by distinguishing characteristics and are not isolated events," and that the Supreme Court has "no reason to suppose that Congress had in mind for RICO's pattern of racketeering component any more constrained a notion of the relationships between predicates that would suffice"); see also *RJR Nabisco, Inc. v. European Community*, 136 S. Ct. 2090, 2096-97, 195 L. Ed. 2d 476, R.I.C.O. Bus. Disp. Guide (CCH) P 12729 (2016) ("A predicate offense implicates RICO when it is part of a 'pattern of racketeering activity'—a series of *related* predicates that together demonstrate the existence or threat of continued criminal activity.") (citing *H.J. Inc. v. Northwestern Bell Telephone Co.*, 492 U.S. 229, 240, 109 S. Ct. 2893, 106 L. Ed. 2d 195, R.I.C.O. Bus. Disp. Guide (CCH) P 7237, 103 Pub. Util. Rep. 4th (PUR) 513 (1989)) (emphasis added); *Blue Line Coal Co., Inc. v. Equibank*, 769 F. Supp. 891, 895, R.I.C.O. Bus. Disp. Guide (CCH) P 7823 (E.D. Pa. 1991) ("To satisfy the relatedness test, the alleged predicate acts must be 'interrelated by distinguishing characteristics and . . . not isolated events.' ") (citing *H.J. Inc. v. Northwestern Bell Telephone Co.*, 492 U.S. 229, 240, 109 S. Ct. 2893, 106 L. Ed. 2d 195, R.I.C.O. Bus. Disp. Guide (CCH) P 7237, 103 Pub. Util. Rep. 4th (PUR) 513 (1989)).

[8]*H.J. Inc. v. Northwestern Bell Telephone Co.*, 492 U.S. 229, 241-43, 109 S. Ct. 2893, 106 L. Ed. 2d 195, R.I.C.O. Bus. Disp. Guide (CCH) P 7237, 103 Pub. Util. Rep. 4th (PUR) 513 (1989) ("The continuity requirement is likewise satisfied where it is shown that the predicates are a regular way of conducting defendant's ongoing legitimate business (in the sense that it is not a business that exists for criminal purposes), or of conducting or participating in an ongoing and legitimate RICO 'enterprise.' ").

[9]*Edwards v. First Nat. Bank, Bartlesville, Oklahoma*, 872 F.2d 347, 352, R.I.C.O. Bus. Disp. Guide (CCH) P 7176 (10th Cir. 1989).

lender and that reliance upon them to establish a pattern of racketeering was "misplaced."

In *Technology Exchange Corp. v. Grant County State Bank*,[10] the court stated that "the occurrence of several predicate acts may fail to establish a pattern of racketeering activity when those acts are directed towards a single fraudulent scheme." The court then held that the continuity component was not satisfied since the alleged activity was all directed to induce the borrower to enter into a single service contract. Similarly, in *Blue Line Coal Co., Inc. v. Equibank*,[11] the court held that the continuity component was not satisfied where the borrower established that the lender breached a workout agreement but failed to establish that the allegedly fraudulent acts, which occurred within a matter of months, constituted the lender's regular way of doing business. The Third Circuit and the District of Columbia Circuit have adopted a multifactor test to determine whether a pattern has been established.[12] The courts look to "the number of unlawful acts, the length of time over which the acts were committed, the similarity of the acts, the number of victims, the number of perpetrators, and the character of the unlawful activity."[13]

### § 174:46 Control of an enterprise

A lender may be liable under RICO if it acquires or maintains an interest in or control of an enterprise through a pattern of racketeering activity or the collection of an unlawful debt. Whether liability is imposed depends on the amount of control extended by the lender, among other things. Section 1962(b) provides:

> It shall be unlawful for any person through a pattern of racketeering activity or through collection of an unlawful debt to acquire or maintain, directly or indirectly, any interest in or

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[10] *Technology Exchange Corp. of America, Inc. v. Grant County State Bank*, 646 F. Supp. 179, 183, Fed. Sec. L. Rep. (CCH) ¶ 93100, R.I.C.O. Bus. Disp. Guide (CCH) P 6449 (D. Colo. 1986) (internal citations omitted).

[11] *Blue Line Coal Co., Inc. v. Equibank*, 769 F. Supp. 891, 897, R.I.C.O. Bus. Disp. Guide (CCH) P 7823 (E.D. Pa. 1991).

[12] See, e.g., *Edmondson & Gallagher v. Alban Towers Tenants Ass'n*, 48 F.3d 1260, R.I.C.O. Bus. Disp. Guide (CCH) P 8843 (D.C. Cir. 1995); *Kehr Packages, Inc. v. Fidelcor, Inc.*, 926 F.2d 1406, 1411-13, R.I.C.O. Bus. Disp. Guide (CCH) P 7713 (3d Cir. 1991).

[13] *Edmondson & Gallagher v. Alban Towers Tenants Ass'n*, 48 F.3d 1260, 1265, R.I.C.O. Bus. Disp. Guide (CCH) P 8843 (D.C. Cir. 1995) (citing *Kehr Packages, Inc. v. Fidelcor, Inc.*, 926 F.2d 1406, 1411-13, R.I.C.O. Bus. Disp. Guide (CCH) P 7713 (3d Cir. 1991)) (internal citation omitted); Watson v. Faris, 139 F. Supp. 3d 456, 460 (D.D.C. 2015) (setting forth factors).

> control of any enterprise which is engaged in, or the activities of which affect, interstate or foreign commerce.[1]

Under this provision, a lender may be liable for racketeering activity if it obtains ownership of the, borrower or control over the borrower's day-to-day operations. Such control must amount to more than "the normal incidents of a borrower-lender relationship, including monitoring, protection and disposition of collateral"; rather "[a]ctual day-to-day involvement in management and operations of the borrower or the ability to compel the borrower to engage in unusual transactions is required for the purposes of showing that a lending institution had control over a borrower."[2]

### § 174:47 Participate in an enterprise's affairs

A lender may be liable under RICO if it conducts or participates in the affairs of an enterprise through a pattern of racketeering activity or the collection of an unlawful debt. Section 1962(c) provides:

> It shall be unlawful for any person employed by or associated with any enterprise engaged in, or the activities of which affect, interstate or foreign commerce, to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs through a pattern of racketeering activity or collection of unlawful debt.[1]

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[Section .46]

[1] 18 U.S.C.A. § 1962(b).

[2] *NCNB Nat. Bank of North Carolina v. Tiller*, 814 F.2d 931, R.I.C.O. Bus. Disp. Guide (CCH) P 6573, 7 Fed. R. Serv. 3d 463 (4th Cir. 1987) (overruled on other grounds by, *Busby v. Crown Supply, Inc.*, 896 F.2d 833, 114 Lab. Cas. (CCH) P 12032, R.I.C.O. Bus. Disp. Guide (CCH) P 7424 (4th Cir. 1990)) (holding that a lender did not obtain control over the borrower based on its right to demand payment on its loan); see also *Blank v. Optimum Financial Services, LLC*, 2017 WL 1508990, *4 (E.D. Pa. 2017), appeal dismissed, 2017 WL 5634297 (3d Cir. 2017) ("Control over the borrower is established when evidence exists that the lender was involved in the actual day-to-day management and operations of the borrower or that the lender had the ability to compel the borrower to engage in unusual transactions.") (internal citation omitted); *Moffatt Enterprises, Inc. v. Borden, Inc.*, 763 F. Supp. 143 (W.D. Pa. 1990) ("The 'control' contemplated is in the nature of the control one gains through the acquisition of sufficient stock to affect the composition of a board of directors"); *P.M.F. Services, Inc. v. Grady*, 681 F. Supp. 549, 556 (N.D. Ill. 1988) (dismissing complaint, which alleged that lender acquired an "interest" in the borrower by acquiring the borrower's money, finding that "[w]hile [the lender] may perhaps have obtained a possessory interest in funds rightfully belonging to [the borrower], it certainly obtained no interest in [the borrower] itself, and that is the operative requirement under Section 1962(b)").

[Section .47]

[1] 18 U.S.C,A, § 1962(c).

Courts varied regarding the degree of involvement required before a lender can be found liable for participating in the borrower's affairs. Some courts have held that a lender must "participate in the operation or management of the enterprise," while others "merely require that the predicate acts be related to or have an effect upon the enterprise's affairs."[2] For example, in *Odesser v. Continental Bank*,[3] the plaintiff alleged that it lost control of the borrowing corporation based on a fraudulent board resolution, which deprived it of the ability to draw funds from the borrower's bank account, The court held that participation in the management of the borrower was not required and that the plaintiff sufficiently alleged a cause of action against the lender based on the lender's knowledge that the board resolution was fraudulent and refusal to honor checks signed by the plaintiff.[4]

The Supreme Court resolved the circuit split in *Reves v. Ernst & Young*[5] and interpreted 18 U.S.C.A. § 1962(c) as requiring participation in the "operation or management" rather than the more liberal approach adopted in *Odesser*. Under the *Reves* case, a defendant must play some role in directing or operating the affairs of an enterprise to be found liable, but "liability under § 1962(c) is not limited to upper management," as an enterprise may be operated "by lower rung participants in the enterprise who are under the direction of upper management."[6] Several courts have looked to the Reyes decision to interpret the various ways in which a defendant can participate in the conduct of an enterprise.

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[2]See *Virden v. Graphics One*, 623 F. Supp. 1417, 1427, R.I.C.O. Bus. Disp. Guide (CCH) P 6128, R.I.C.O. Bus. Disp. Guide (CCH) P 6137 (C.D. Cal. 1985) (discussing split in authority).

[3]*Odesser v. Continental Bank*, 676 F. Supp. 1305, 1311 (ED. Pa. 1987).

[4]*Odesser v. Continental Bank*, 676 F. Supp. 1305, 1311-12 (E.D. Pa. 1987).

[5]*Reves v. Ernst & Young*, 507 U.S. 170, 113 S. Ct. 1163, 1173, 122 L. Ed. 2d 525, Fed. Sec. L. Rep. (CCH) P 97,357, R.I.C.O. Bus. Disp. Guide (CCH) P 8227 (1993) (holding that "the legislative history confirms what we have already deduced from the language of § 1962(c)—that one is not liable under the provision unless one has participated in the operation or management of the enterprise itself'").

[6]*Reves v. Ernst & Young*, 507 U.S. 170, 184, 113 S. Ct. 1163, 1173, 122 L. Ed. 2d 525, Fed. Sec. L. Rep. (CCH) P 97,357, R.I.C.O. Bus. Disp. Guide (CCH) P 8227(1993); see also *George v. Urban Settlement Services*, 833 F.3d 1242, 1251, R.I.C.O. Bus. Disp. Guide (CCH) P 12761 (10th Cir. 2016) ("Under *Reves'* operation or management test, the defendant must have some part in directing the enterprise's affairs. But importantly, the defendant need not have primary responsibility for the enterprise's affairs, a formal position in the enterprise, or significant control over or within an enterprise. Instead, even lower rung participants in the enterprise who are under the direction of upper management may be liable under RICO if they have some part in operating or managing the enterprise's affairs") (internal citations omitted).

For example, in *Sundial Int'l. Fund Ltd. v. Delta Consultants, Inc.*,[7] investors sued several lenders on the theory that the lenders aided and abetted a currency trader's fraudulent schemes. The investors alleged that the currency trader defrauded investors through false reports which induced them to invest their funds with him. In order to carry out the trading, the trader established currency exchange accounts with the lender defendants. The court found that even if the lenders aided and abetted the trader's fraud, the lenders were not part of the trader's operations because they did not participate with him in soliciting the investments and did not play any role in directing the currency trader's operation.

### § 174:48 Invest in enterprise

A lender may be liable under RICO if it uses or invests income derived from a pattern of racketeering activity or the collection of an unlawful debt to acquire an interest in or to establish the operation of an enterprise. Section 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 had 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.[1]

Similar to § 1962(b), a lender may be liable for racketeering activity under § 1962(a) if it obtains ownership of the borrower.

## D. SECURITIES LAWS

### § 174:49 Generally

A lender may be liable for the borrower's violation of the Securities Act of 1933 (the "Securities Act"),[1] the Exchange Act of 1934 (the "Exchange Act"),[2] and various state "blue sky" laws.[3] The Securities Act

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[7] *Sundial Intern, Fund Ltd. v. Delta Consultants, Inc.*, 923 F. Supp. 38, Comm. Fut. L. Rep. (CCH) P 26737, R.I.C.O. Bus. Disp. Guide (CCH) P 9069 (S.D. N.Y. 1996).

[Section .48]

[1] 18 U.S.C.A. § 1962(a).

[Section .49]

[1] 15 U.S.C.A. §§ 77a to 77aa.

[2] 15 U.S.C.A. §§ 78a to 78jj.

[3] See, e.g., Uniform Securities Act, 7B U.L.A. 509 (1985).

focuses primarily on the distribution of securities while the Securities Exchange Act focuses primarily on the post-distribution trading of securities.[4] Section 12 of the Securities Act provides liability for the offer or sale of unregistered securities and for fraud in the offer or sale of securities.[5] Section 11 of the Securities Act provides for liability for misstatements or omissions contained in a "registration statement,"[6] Section 10(b) of the Exchange Act, along with SEC Rule 10b-5, provides for liability based on fraud in the trading of securities.[7]

### § 174:50 Controlling person liability

While Section 10(b) of the Exchange Act generally forms the basis for federal securities fraud liability against primary violators, it cannot be used by private parties to establish liability on third parties for aiding and abetting the securities fraud committed by a primary violator.[1] In *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*,[2] the Supreme Court held that a private plaintiff cannot bring an aiding and abetting case under Section 10(b) of the Exchange Act. The Court went on to acknowledge that its holding "does not mean that secondary actors in the securities markets are always free from liabilities under the securities Acts. Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator" if the requirements for primary liability are met."[3]

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[4]See, generally Joel Seligman, Troy A. Paredes & Louis Loss, Fundamentals of Securities Regulation (7th ed. 2018).

[5]15 U.S.C.A. § 77l.

[6]15 U.S.C.A. § 77k.

[7]15 U.S.C.A. § 78j; 17 C.F.R. 240.10b-5.

[Section .50]

[1]Conspiracy liability differs from aiding and abetting liability. A conspiracy requires an agreement pursuant to which the parties become mutual agents of each other and, consequently, liable for each others' acts. Aiding and abetting liability, conversely, involves primary and secondary liability, with secondary liability imposed on the aider and abettor based on actual knowledge of the primary violation and rendering substantial assistance to the violator. See Restatement Second, Torts § 876 (1977).

[2]*Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191, 114 S. Ct. 1439, 128 L. Ed. 2d 119, Fed. Sec. L. Rep. (CCH) P 98178 (1994) (analyzing Congress' intent).

[3]*Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191, 114 S. Ct. 1439, 128 L. Ed. 2d 119, Fed. Sec. L. Rep. (CCH) P 98178 (1994) (concluding that the District Court's grant of summary judgment to lender as to aiding and abetting claim under Section 10(b) of the Exchange Act was proper).

Under the Private Securities Litigation Reform Act, enacted in 1995,[4] Congress confirmed that the Securities and Exchange Commission's ("SEC") enforcement authority extends to aiding and abetting securities fraud under Section 10(b) of the Exchange Act, but declined to extend a similar right of action to private plaintiffs.[5]

In the wake of *Central Bank*, courts turned to the issue of determining who would be considered a primary violator subject to liability under Section 10(b). Private plaintiffs, as well as the SEC, advanced the theory that third-party defendants could be primarily liable if they were engaged, directly or indirectly, in a manipulative or deceptive act as part of a "scheme to defraud" investors. However, in *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*,[6] the Supreme Court rejected this theory of "scheme liability," on the basis that-because the third-party defendants did not have a duty to disclose any material information, and their deceptive acts were not made public at the time they were made, the plaintiffs could not establish that defendants actually relied upon the defendants' deceptive conduct. To hold otherwise, the Court reasoned, would subject the "whole market-place in which the issuing company does business" to liability.[7]

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[4]Private Securities Litigation Reform Act (PSLRA), Pub. L. No. 104-67, 109 Stet 737 (1995).

[5]A lender may be liable for aiding and abetting a borrower's violation if: (1) the lender had actual knowledge (scienter) of the borrower's violation and (2) substantially assisted the borrower in committing the violation. See generally Restatement Second, Torts § 876(b) (1977).

[6]*Stoneridge Inv. Partners, LLC v. Scientific-Atlanta*, 552 U.S. 148, 128 S. Ct. 761, 769, 169 L. Ed. 2d 627, Fed. Sec. L. Rep. (CCH) P 94556 (2008) ("Respondents had no duty to disclose; and their deceptive acts were not communicated to the public. No member of the investing public had knowledge, either actual or presumed, of respondents' deceptive acts during the relevant times. Petitioner, as a result, cannot show reliance upon any of respondents' actions except in an indirect chain that we find too remote for liability."); see also *West Virginia Pipe Trades Health & Welfare Fund v. Medtronic, Inc.*, 845 F.3d 384, 393-94, Fed. Sec. L. Rep. (CCH) P 99488 (8th Cir. 2016) (relying on *Stoneridge* rather than on theory of scheme liability to analyze remoteness of causal connection between appellee's alleged deceptive conduct and information on which the market relied).

[7]*Stoneridge Inv. Partners, LLC v. Scientific-Atlanta*, 552 U.S. 148, 128 S. Ct. 761, 770, 169 L. Ed. 2d 627, Fed. Sec. L. Rep. (CCH) P 94556 (2008) (explaining that there is no authority for such rule).

## § 174:51 Aiding and abetting liability

Lenders may be secondarily liable for the securities violations of a borrower based on a theory of aiding and abetting.[1] A lender may be liable for aiding and abetting a borrower's violation if the lender: (1) had actual knowledge (scienter) of the borrower's violation, and (2) substantially assisted the borrower in committing the violation.[2] Aiding and abetting liability generally arose under Section 10(b) of the Exchange Act. However, in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*,[3] the Supreme Court held that a private plaintiff cannot bring an aiding and abetting case under § 10(b). The Court went on to acknowledge that its holding

> [D]oes not mean that secondary actors in the securities markets are always free from liabilities under the securities Acts. Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator" if the requirements for primary liability are met.[4]

The Second and Eleventh Circuits have interpreted Central Bank to require a bright-line test, finding that in order fora secondary actor to be liable, "the alleged misstatement or omission upon which a plaintiff relied must have been publicly attributable to the defendant at the time

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[1]Conspiracy liability differs from aiding and abetting liability. A conspiracy requires an agreement pursuant to which the parties become mutual agents of each other and, consequently, liable for each others' acts. Aiding and abetting liability, conversely, involves primary and secondary liability with secondary liability imposed on the aider and abettor based on actual knowledge of the violation and rendering substantial assistance to the violator. See Restatement Second, Torts § 876 (1977).

[2]E.g., *Sanders Confectionery Products, Inc. v. Heller Financial, Inc.*, 973 F.2d 474, Bankr. L. Rep. (CCH) ¶ 74917, Fed. Sec. L. Rep. (CCH) ¶ 96966, R.I.C.O. Bus. Disp. Guide (CCH) ¶ 8063 (6th Cir. 1992) (holding that lender was not liable under aiding and abetting theory where borrower lacked requisite scienter to establish primary violation); *Edwards & Hanly v. Wells Fargo Securities Clearance Corp.*, 602 F.2d 478, 483 n.5, Fed. Sec. L. Rep. (CCH) ¶ 96916 (2d Cir. 1979); *Metge v. Baehler*, 762 F.2d 621, 624, Fed. Sec. L. Rep. (CCH) ¶ 92037 (8th Cir. 1985); *Morganroth & Morganroth v. Norris, McLaughlin & Marcus, P.C.*, 331 F.3d 406, 416 (3d Cir. 2003); see also Restatement Second, Torts § 876(b) (1977).

[3]*Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 114 S. Ct. 1439, 128 L. Ed. 2d 119, Fed. Sec. L. Rep. (CCH) P 98178 (1994).

[4]*Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 114 S. Ct. 1439, 1455, 128 L. Ed. 2d 119, Fed. Sec. L. Rep. (CCH) P 98178 (1994).

that the plaintiff's investment decision was made."[5] The Ninth Circuit has adopted a "substantial participation" test in which the secondary party is liable when there is a "substantial participation or intricate involvement" by the secondary party in preparation of any fraudulent statements.[6]

A district court in *In re Enron Corp. Securities, Derivative & ERISA Litigation*[7] has rejected both tests and adopted a test proposed by the SEC, holding that when a person makes a misrepresentation on which an investor relies, that person can be liable as a primary violator if the person acts with scienter, even if he did not initiate the misrepresentation. In explaining its test, the court found that proof of reliance on the misrepresentation and not reliance on the, fact that a specific person made the misrepresentation is essential under the reliance requirement.

### E. INTERNAL REVENUE CODE

### § 174:52 Generally

A lender may be liable for the borrower's unpaid payroll withholding taxes. Moreover, a lender must establish its own procedure to determine whether the borrower is making the required payroll tax deposits. In *Jersey Shore State Bank v. U.S.*,[1] the Supreme Court held that although Internal Revenue Code § 6303(a) requires that 60-days notice be given to each person liable for the unpaid tax, the United States does not have to give such notice to lenders.

### § 174:53 Liability for supplying payroll funds

A lender may be liable under the Internal Revenue Code (IRC)[1] if it (1) supplies funds to the borrower for the specific purpose of paying wages, and (2) has actual knowledge that the borrower would not pay

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[5] *Ziemba v. Cascade Intern., Inc.*, 256 F.3d 1194, 1205, Fed. Sec. L. Rep. (CCH) P 91470, 50 Fed. R. Serv. 3d 335 (11th Cir. 2001); accord *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175, Fed. Sec. L. Rep. (CCH) P 90266 (2d Cir. 1998).

[6] *Howard v. Everex Systems, Inc.*, 228 F.3d 1057, 1061 n.5, Fed. Sec. L. Rep. (CCH) P 91217 (9th Cir. 2000).

[7] *In re Enron Corp. Securities, Derivative & ERISA Litigation*, 235 F. Supp. 2d 549, 588, Fed. Sec. L. Rep. (CCH) P 92239 (S.D. Tex. 2002).

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[1] *Jersey Shore State Bank v. U.S.*, 479 U.S. 442, 107 S. Ct. 782, 93 L. Ed. 2d 800, Unempl. Ins. Rep. (CCH) P 17084, 87-1 U.S. Tax Cas. (CCH) ¶ 9131, 59 A.F.T.R.2d 87-413 (1987).

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[1] 26 U.S.C.A. §§ 1 et seq.

the required payroll withholding taxes. Section 3505(b) of the IRC provides:

> If a lender . . . supplies funds to or for the account of an employer for the specific purpose of paying wages of the employees of such employer, with actual notice or knowledge (within the meaning of § 6323(i)(1)) that such employer does not intend to or will not be able to make timely payment or deposit of the amounts of tax required by this subtitle to be deducted and withheld by such employer from such wages, 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) which are not paid over to the United States by such employer with respect to such wages. However, the liability of such lender . . . shall be limited to an amount equal to 25 percent of the amount so supplied to or for the account of such employer for such purpose.[2]

As explained in the corresponding Treasury Regulations, § 3505(b) does not apply to a lender that makes an ordinary working capital loan with knowledge that some of the funds may be used to pay wages in the ordinary course of business since the lender is not required to determine the specific use of an ordinary working capital loan or the borrower's ability to pay the payroll withholding taxes.[3] However, in *O'Hare v. U.S.*,[4] the Sixth Circuit held that a lender was not entitled to a jury instruction regarding the nonapplicability of § 3505(b) where the lender asserted that it did not control the borrower's use of funds after their transfer since the test is based on knowledge, not control. Similarly, in *Fidelity Bank, N.A. v. U.S.*,[5] the Tenth Circuit held that a lender was liable under § 3505(b) when it honored payroll checks that were drawn in excess of the borrower's credit line since each check constituted a separate loan and the lender made these loans with knowledge that the borrower did not have funds available to pay the corresponding payroll withholding taxes.

A lender may be liable under § 6672 of the Internal Revenue Code (IRC) for a penalty equal to 100% of the borrower's unpaid payroll

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[2]26 U.S.C.A. § 3505(b).

[3]Treas. Reg. § 31.3505-1(b)(3).

[4]*O'Hare v. U.S.*, 878 F.2d 953, 958, 89-2 U.S. Tax Cas. (CCH) ¶ 9436, 64 A.F.T.R.2d 89-5170 (6th Cir. 1989).

[5]*Fidelity Bank, N. A. v. U.S.*, 616 F.2d 1181, 1184, 80-1 U.S. Tax Cas. (CCH) P 9275, 45 A.F.T.R.2d 80-970 (10th Cir. 1980).

withholding taxes if the lender is found to be a "responsible person." Section 6672 provides:

> Any person required to collect, truthfully account for, and pay over any tax imposed by this title who willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof, shall, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over.[1]

A lender may be deemed to be a responsible person under § 6672 if it controls the borrower's financial management. For example, in *Commonwealth Nat. Bank of Dallas v. U.S.*,[2] the Fifth Circuit held that a lender was a responsible person since the borrower had no unencumbered funds that it could use to pay the withholding taxes and any control that it had over its bank account was shared with the lender. The court stated that "[w]hat will subject a bank to liability for those taxes is the assumption of control over how the employer's funds are to be spent and over the process of deciding which creditors of the employer are to be paid and which are not, and when."[3] Conversely, in *Fidelity Bank, N.A. v. U.S.*,[4] the Tenth Circuit held that, although the lender was liable under § 3505(b), it was not a responsible person under § 6672 since the lender did not initiate payment decisions or decide which creditors were to be paid. The court also held that although the lender could have coerced the borrower to pay the withholding taxes, the lender did not have a duty to do so since it had not otherwise intruded into the financial or operational aspects of the borrower's business.

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[1] 26 U.S.C.A. § 6672(a); see also 26 U.S.C.A. § 6671 (defining "person"); 26 U.S.C.A. § 7501(a) (providing liability for depositing payroll withholding taxes).

[2] *Commonwealth Nat. Bank of Dallas v. U.S.*, 665 F.2d 743, 757, 82-1 U.S. Tax Gas. (CCH) ¶ 9149, 49 A.F.T.R.2d 82-647 (5th Cir. 1982).

[3] *Commonwealth Nat. Bank of Dallas v. U.S.*, 665 F.2d 743, 757, 82-1 U.S. Tax Cas. (CCH) ¶ 9149, 49 A.F.T.R.2d 82-647 (5th Cir. 1982).

[4] *Fidelity Bank, N.A. v. U.S.*, 616 F.2d 1181, 1186, 80-1 U.S. Tax Cas. (CCH) ¶ 9275, 45 A.F.T.R.2d 80-970 (10th Cir. 1980).

### F. FAIR LABOR STANDARDS ACT

### § 174:54 Generally

A lender may be liable for a borrower's violation of the Fair Labor Standards Act (FLSA)[1] if it forecloses and seeks to sell goods produced in violation of the FLSA. Section 215 provides:

> (a) it shall be unlawful for any person—
> (1) to . . . sell in commerce . . . any goods in the production of which any employee was employed in violation of § 206 [minimum wage] or § 207 [overtime] of this title, or in violation of any regulation or order of the Secretary issued under § 214 of this title . . . .

In *Citicorp Indus. Credit, Inc. v. Brock*,[2] the Supreme Court held that, pursuant to § 215(a)(1), the secured creditor was not allowed to sell goods it acquired by foreclosure until the borrower's employees were paid the wages owed them under the FLSA. In *Brock v. Rusco Industries, Inc.*,[3] the Eleventh Circuit held that the Bankruptcy Code's automatic stay did not stay an action by the Secretary of Labor to enjoin the debtor from selling goods manufactured in violation of the FLSA.

## IV. LITIGATION STRATEGIES

### A. PRETRIAL MOTIONS

### § 174:55 Generally

After a suit is commenced against a lender on contractual, tort, or statutory grounds, both the plaintiffs and defendants are well advised to consider a host of issues that are unique to lender liability actions. This division primarily focuses on issues that may arise during the pretrial phase of litigation. Loan documents may contain arbitration clauses, forum selection clauses, choice of law provisions, waivers and releases, and jury trial waivers, which parties may seek to enforce. The nature of lender liability claims may also involve unique issues concerning a plaintiff's standing to bring suit against the lender, the overlap between tort and contract claims, and the preclusive effect of prior adjudication of related claims.

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[1] 29 U.S.C.A. §§ 201 et seq.

[2] *Citicorp Indus. Credit, Inc. v. Brock*, 483 U.S. 27, 107 S. Ct. 2694, 97 L. Ed. 2d 23, 17 Collier Bankr. Cas. 2d (MB) 875, 28 Wage & Hour Cas. (BNA) 141, 106 Lab. Cas. (CCH) ¶ 34915 (1987).

[3] *Brock v. Rusco Industries, Inc.*, 842 F.2d 270, 18 Collier Bankr. Cas. 2d (MB) 728, 28 Wage & Hour Cas. (BNA) 937, Bankr. L. Rep. (CCH) ¶ 72250, 108 Lab. Cas. (CCH) ¶ 35052 (11th Cir. 1988).

## § 174:56 Enforceability of arbitration clauses

A party may file a motion to dismiss a complaint or stay civil litigation in favor of arbitration under the Federal Arbitration Act (the Act).[1] The Act provides that valid, written arbitration clauses in contracts evidencing transactions involving, inter alia, "commerce" are "valid, irrevocable, and enforceable" in the courts of the United States under the Act.[2]

Section 1 of the Act defines "commerce" to include, without limitation, "commerce among the several States or with foreign nations." Accordingly, courts have held that the Act, while applicable to transactions in interstate commerce, is not applicable to transactions in intrastate commerce.[3] Some courts have applied the Act to enforce arbitration clauses where the parties expressly agreed under the applicable contract that the transactions involved "commerce" as defined under the Act.[4] A contract or agreement that is not predicated

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[1]Federal Arbitration Act, 9 U.S.C.A. §§ 1 to 16. See, generally, Wilner, Domke on Commercial Arbitration.

[2]Specifically, Section 2 of the Act provides:

> A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.

9 U.S.C.A. § 2.

[3]Compare *Maxum Foundations, Inc. v. Salus Corp.*, 779 F.2d 974, 978 (4th Cir. 1985) (discussing burden of proof in determining whether contract involved interstate commerce); with *Thomas O'Connor & Co., Inc. v. Insurance Co. of North America*, 697 F. Supp. 563, 565 (D. Mass. 1988) (finding that the FAA's provision will apply only where the contract evidences a transaction involving interstate commerce). See also, *U.S. v. Downs*, 299 Fed. Appx. 310 (5th Cir. 2008) (finding that the FAA applied because the challenged conduct implicated interstate commerce); *Waveform Telemedia, Inc. v. Panorama Weather North America*, 2007 WL 678731, *4 (S.D. N.Y. 2007) ("The FAA is applicable if a contract concerns a transaction involving interstate commerce."); *CarMax Auto Superstores California LLC v. Hernandez*, 94 F. Supp. 3d 1078 (C.D. Cal. 2015) (holding that the contract in question was governed by the FAA because the activities involved interstate commerce).

[4]See, e.g., *Staples v. Money Tree, Inc.*, 936 F. Supp. 856, 858 (M.D. Ala. 1996); *In re Knepp*, 229 B.R. 821, 834 (Bankr. N.D. Ala. 1999).

upon interstate commerce will be governed by state arbitration law,[5] which includes statutes based upon the Uniform Arbitration Act.

Federal substantive law governs issues regarding the construction, enforceability, and scope of arbitration agreements which fall within the ambit of the Act.[6] The Act expresses a strong federal policy favoring arbitration. That policy has been articulated at all levels of the federal judicial system, including the United States Supreme Court.[7] For example, in *Moses H. Cone Memorial Hosp. v. Mercury Const. Corp.*,[8] the Court noted that:

> [T]he Courts of Appeals have . . . consistently concluded that questions of arbitrability must be addressed with a healthy regard for the federal policy favoring arbitration. We agree. The Arbitration Act establishes that, as a matter of federal law, any doubts concerning the scope of arbitrable issues should be

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[5]See *Roodveldt v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 585 F. Supp. 770, 779 (E.D. Pa. 1984); *Shearson Hayden Stone, Inc. v. Liang*, 493 F. Supp. 104, 106 (N.D. Ill. 1980), decision aff'd, 653 F.2d 310 (7th Cir. 1981) ("Interstate commerce is a necessary basis for application of the Arbitration Act, and a contract or agreement not predicated upon interstate commerce must be governed by state arbitration law,"); see also *Howard Fields & Associates v. Grand Wailea Co.*, 848 F. Supp. 890, 893 (D. Haw. 1993) (if transactions between parties does not implicate interstate commerce, under the Erie doctrine, applicable to diversity cases, the court must apply the forum state's substantive law, including choice of law rules).

[6]See *Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24, 103 S. Ct. 927, 941, 74 L. Ed. 2d 765 (1983) (the FAA creates a "body of federal substantive law of arbitrability, applicable to any arbitration agreement within the coverage of the Act"); see also *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 105 S. Ct. 3346, 87 L. Ed. 2d 444, 1985-2 Trade Cas. (CCH) ¶ 66669 (1985) ("[T]he Act simply "creates a body of federal substantive law establishing and regulating the duty to honor an agreement to arbitrate."); *McPheeters v. McGinn, Smith and Co., Inc.*, 953 F.2d 771, 772, Fed. Sec. L. Rep. (CCH) ¶ 96485 (2d Cir. 1992) ("Federal law . . . governs the current dispute as to the scope of the Agreement"); *Hoffman v. Fidelity and Deposit Co. of Maryland*, 734 F. Supp. 192, 194 (D.N.J. 1990) ("In all contracts governed by the Federal Arbitration Act, questions as to the construction and enforceability of arbitration agreements are controlled by federal substantive law").

[7]See, e.g., *Shearson / American Exp., Inc. v. McMahon*, 482 U.S. 220, 107 S. Ct. 2332, 96 L. Ed. 2d 185, Fed. Sec. L. Rep. (CCH) ¶ 93265, R.I.C.O. Bus. Disp. Guide (CCH) P 6642 (1987) ("The Arbitration Act thus establishes a federal policy favoring arbitration, requiring that "we rigorously enforce agreements to arbitrate.") (internal citations omitted); *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 105 S. Ct. 3346, 87 L. Ed. 2d 444, 1985-2 Trade Cas. (CCH) ¶ 66669 (1985) ("The liberal federal policy favoring arbitration agreements, manifested by this provision and the Act as a whole, is at bottom a policy guaranteeing the enforcement of private contractual arrangements.") (internal citation omitted).

[8]*Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 103 S. Ct. 927, 74 L. Ed. 2d 765 (1983).

resolved in favor of arbitration, whether the problem at hand is the construction of the contract language itself or an allegation of waiver, delay, or a like defense to arbitrability.[9]

Standard contract law provides parties with the basis for attacking the validity of arbitration clauses. Section 2 of the Act provides that written arbitration clauses in contracts evidencing transactions in commerce are "valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contracts."[10] Thus, before a party may be compelled to arbitrate under the Act, the court must engage in a limited inquiry to determine whether a valid agreement to arbitrate exists and whether the specific dispute falls within the scope of that agreement.[11] Grounds for revocation of arbitration clauses include such grounds as would permit revocation or

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[9] *Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24-25, 103 S. Ct. 927, 74 L. Ed. 2d 765 (1983). See also *Huffman v. Hilltop Companies, LLC*, 747 F.3d 391, 396-97, 22 Wage & Hour Cas. 2d (BNA) 508, 164 Lab. Cas. (CCH) P 36214 (6th Cir. 2014) ("But where ambiguity in agreements involving arbitration exists, such as here, the strong presumption in favor of arbitration applies instead."); *Unionmutual Stock Life Ins. Co. of America v. Beneficial Life Ins. Co.*, 774 F.2d 524, 528 (1st Cir. 1985) (dispute is arbitrable unless it "may be said with positive assurance" that the arbitration clause does not cover the dispute); *Johnson Controls, Inc. v. City of Cedar Rapids, Iowa*, 713 F.2d 370 (8th Cir. 1983) ("The Court must also be guided by the 'liberal federal policy favoring arbitration,' "); *M.A. Mortenson Co. v. Gem Mechanical Services, Inc.*, 2006 WL 1997367, *2 (D. Minn. 2006) ("There is a strong federal policy favoring arbitration and all doubts are to be resolved in favor of arbitration.").

[10] 9 U.S,C.A. § 2.

[11] See *Stone v. Doerge*, 328 F.3d 343, 345-46 (7th Cir. 2003) (in determining whether agreement to arbitrate covered dispute, "[n]othing in the Federal Arbitration Act overrides normal rules of contractual interpretation" to determine what the agreement entails); see also *U.S. v. Graef*, 31 F.3d 362, 1994 FED App. 0275P (6th Cir. 1994).

rescission of contracts generally. These include, but are not limited to, fraud, unconscionability, duress, and lack of capacity.[12]

In essence, an agreement to arbitrate a dispute is a waiver of a party's right to a jury trial of the dispute. Thus, to the extent that, under applicable statutory or case law, a waiver of a right to a jury trial will be effective only under certain defined circumstances, a person drafting an arbitration clause should consider the applicability of any rules, procedures, or guidelines concerning jury trial waivers.[13] Although some courts have concluded that a party must voluntarily and knowingly waive its right to a jury trial in order to enforce an agreement to

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[12]See *Shearson / America Exp., Inc. v. McMahon*, 482 U.S. 220, 226, 107 S. Ct. 2332, 96 L. Ed. 2d 185, Fed. Sec. L. Rep. (CCH) ¶ 93265, R.I.C.O. Bus. Disp. Guide (CCH) P 6642 (1987) (stating that "[a]bsent a well-founded claim that an arbitration agreement resulted from the sort of fraud or excessive economic power that would provide grounds 'for the revocation of any contract' " claims based on statute were subject to Federal Arbitration Act) (internal citations omitted); *Cooper v. MRM Investment Co.*, 367 F.3d 493, 498, 93 Fair Empl. Prac, Cas. (BNA) 1290, 2004 FED App. 0126P (6th Cir. 2004) ("[G]enerally applicable state-law contract defenses like fraud, forgery, duress, mistake, lack of consideration or mutual obligation, or unconscionability, may invalidate arbitration agreements"); *Circuit City Stores, Inc. v. Adams*, 279 F.3d 889, 87 Fair Empl. Prac. Cas. (BNA) 1509, 18 I.E.R. Cas. (BNA) 773, 82 Empl. Prac. Dec. (CCH) P 40936 (9th Cir. 2002) ("general contract defenses such as fraud, duress, or unconscionability, grounded in state contract law, may operate to invalidate arbitration agreements"); *New South Federal Sav. Bank v. Anding*, 414 F. Supp. 2d 636 (S.D. Miss. 2005) (in action where bank sought declaratory judgment that borrowers' lender liability claims against bank must be submitted for arbitration, court entertained borrowers' objections that arbitration provision was unenforceable because it was not mutual, lacked consideration, and was procedurally and substantively unconscionable); *N & D Fashions, Inc. v. DHJ Industries, Inc.*, 548 F.2d 722, 20 U.C.C. Rep. Serv. 847 (8th Cir. 1976) (acknowledging that lack of authority by an alleged agent to bind the putative principal under an arbitration clause would nullify the arbitration agreement, but holding that the agent had apparent authority).

[13]See *Walker v. Ryan's Family Steak Houses, Inc.*, 400 F.3d 370, 381, 10 Wage & Hour Cas. 2d (BNA) 609, 150 Lab. Cas. (CCH) P 34961, 2005 FED App. 0115P (6th Cir. 2005) (waiver of jury trial right under arbitration agreement held to a "knowing and voluntary" standard, and fact that agreement did not specifically mention that jury trial rights would be waived, together with other factors, rendered arbitration agreement unenforceable); *Sile v. Crossetti*, 956 F. Supp. 2d 957, 959 (N.D. Ill. 2013) ("[O]ne cannot waive arbitration and leave the implied jury waiver intact since the latter does not exist without the former,"); *TransFirst Holdings, Inc. v. Phillips*, 2007 WL 867264, *3 (N.D. Tex. 2007) (finding that because arbitration agreement was entered into knowingly, jury waiver provision was enforceable).

arbitrate,[14] most courts have concluded that this heightened standard need not apply for a waiver of jury trial rights to be valid.[15] In some instances, courts have even concluded that "the loss of the right to a jury trial is a necessary and fairly obvious consequence of a decision to arbitrate," and therefore an express jury trial waiver was unnecessary where an agreement considers an arbitration clause.[16]

Arbitration provisions may apply to more than purely contractual disputes. Section 3 of the FAA requires the court, upon a timely motion by one of the parties to the arbitration agreement, to stay the trial of the action if the court is satisfied that the issue in dispute is "referable to arbitration under [the arbitration] agreement." Courts have taken an expansive view of the kinds of claims that are arbitrable under

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[14] See, E.g., *Walker v. Ryan's Family Steak Houses, Inc.*, 400 F.3d 370, 381, 10 Wage & Hour Cas. 2d (BNA) 609, 150 Lab. Cas. (CCH) P 34961, 2005 FED App. 0115P (6th Cir. 2005); *Prudential Ins. Co. of America v. Lai*, 42 F.3d 1299, 1305, 66 Fair Empl. Prac. Cas. (BNA) 933, 65 Empl. Prac. Dec. (CCH) P 43365 (9th Cir. 1994) (concluding that "a Title VII plaintiff may only be forced to forego [sic] her statutory remedies and arbitrate her claims if she has knowingly agreed, to submit such disputes to arbitration").

[15] *Caley v. Gulfstream Aerospace Corp.*, 428 F.3d 1359, 1372, 96 Fair Empl. Prac. Cas. (BNA) 1367, 23 I.E.R. Cas. (BNA) 1212, 10 Wage & Hour Cas. 2d (BNA) 1842, 87 Empl. Prac. Dec. (CCH) P 42167, 151 Lab. Cas. (CCH) P 60092 (11th Cir. 2005) (holding "that general contract principles govern the enforceability of arbitration agreements and that no heightened "knowing and voluntary" standard applies."); *American Heritage Life Ins. Co. v. Orr*, 294 F.3d 702, 711 (5th Cir. 2002) (finding the *Wright* "clear and unmistakable" standard and the *Miranda* "voluntarily and knowingly" standard inapplicable in evaluating whether an arbitration agreement was validly agreed to by the parties); *Seus v. John Nuveen & Co., Inc.*, 146 F.3d 175, 183-84, 77 Fair Empl. Prac. Cas. (BNA) 751, 73 Empl. Prac. Dec. (CCH) P 45394, Fed. Sec. L. Rep. (CCH) P 90225 (3d Cir. 1998); *Sydnor v. Conseco Financial Servicing Corp.*, 252 F.3d 302, 307 (4th Cir. 2001).

[16] *Sydnor v. Conseco Financial Servicing Corp.*, 252 F.3d 302, 307 (4th Cir. 2001) (internal citations omitted); see also *Cooper v. MRM Investment Co.*, 367 F.3d 493, 506, 93 Fair Empl. Prac. Cas. (BNA) 1290, 2004 FED App. 0126P (6th Cir. 2004) ("This Court, however, has flatly rejected the claim that an arbitration agreement must contain a provision expressly waiving the employee's right to a jury trial"); *Caley v. Gulfstream Aerospace Corp.*, 428 F.3d 1359, 1372, 96 Fair Empl. Prac. Cas. (BNA) 1367, 23 I.E.R. Cas. (BNA) 1212, 10 Wage & Hour Cas. 2d (BNA) 1842, 87 Empl. Prac. Dec. (CCH) P 42167, 151 Lab. Cas. (CCH) P 60092 (11th Cir. 2005) (stating that even without express waiver of jury trial, acceptance of arbitration agreement "probably would satisfy even a heightened 'knowing and voluntary' standard"); *Burden v. Check Into Cash of Kentucky, LLC*, 267 F.3d 483, 492, R.I.C.O. Bus. Disp. Guide (CCH) P 10181, 2001 FED App. 0349P (6th Cir. 2001).

arbitration clauses.[17] In *In re Oil Spill by Amoco Cadiz Off Coast of France March 16, 1978*,[18] the court stated:

> Whether a particular claim is arbitrable depends not upon the characterization of the claim, but upon the relationship of the claim to the subject matter of the arbitration clause. Were the rule otherwise, a party could frustrate any agreement to arbitrate simply by the manner in which it framed its claims.[19]

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[17]See *Mehler v. Terminix Intern. Co. L.P.*, 205 F.3d 44, 50 (2d Cir. 2000) (finding arbitrable claims that "touch" the agreement, and analyzing case law on the topic).

[18]*In re Oil Spill by Amoco Cadiz Off Coast of France March 16, 1978*, 659 F.2d 789, 1981 A.M.C. 2407 (7th Cir. 1981) (tort claims arising out of the salvage of a tanker, including but not limited to claims for negligence and breach of an alleged warranty of seaworthiness, were arbitrable under an arbitration clause in the salvage agreement between the parties).

[19]*In re Oil Spill by Amoco Cadiz Off Coast of France March 16, 1978*, 659 F.2d 789, 794, 1981 A.M.C. 2407 (7th Cir. 1981). See also *Morgan v. Smith Barney, Harris Upham & Co.*, 729 F.2d 1163 (8th Cir. 1984) ("Arbitration cannot be made dependent on the simple characterization of a dispute as a tort or contract claim").

In accordance with this expansive view of arbitrable claims under the FAA, courts have held contract,[20] tort,[21] and statutory[22] claims subject to arbitration. For example, in *Anders v. Hometown Mortg. Services, Inc.*,[23] a lender moved to compel the arbitration of a residential mortgage borrower's statutory claims under the Federal Truth in Lending Act (TILA) and Real Estate Settlement Procedures Act (RESPA) based on an arbitration agreement previously executed between the parties. The borrower argued that because the agreement contained remedial limitations (specifically, against punitive damages, treble damages, penalties, and attorney's fees) which were contrary to the full remedies to which the borrower was entitled under the statutes, the arbitration agreement either could not have been intended by the parties to reach such statutory claims, or should not be enforced because it defeated the remedial purposes of the statutes.[24] The court dismissed the borrower's argument that the parties could not have intended that

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[20]See, e.g., *Citizens Bank v. Alafabco, Inc.*, 539 U.S. 52, 123 S. Ct. 2037, 156 L. Ed. 2d 46, 10 A.L.R. Fed. 2d 837 (2003) (debt restructuring agreements); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Hovey*, 726 F.2d 1286, 1291 (8th Cir. 1984) (action against former employees, who sought to compel arbitration under New York Stock Exchange Rule providing for arbitration of any controversy arising out of employment or termination of employment of representative, was subject to arbitration; factual circumstances, regarding alleged use of records and solicitation of business, related to breach of contract); *Berkery v. Cross Country Bank*, 256 F. Supp. 2d 359 (E.D. Pa. 2003) (holding that dispute regarding credit report fell within scope of arbitration clause).

[21]See, e.g., *Collins & Aikman Products Co. v. Building Systems, Inc.*, 58 F.3d 16, 23 (2d Cir. 1995) (mere fact that claim is for tort, rather than for breach of contract, does not make the claim any less arbitrable); *Great Lengths Universal Hair Extensions S.r.L. v. Gold*, 2017 WL 1731184, *7 (S.D. N.Y. 2017) (same); *Morgan v. Smith Barney, Harris Upham & Co.*, 729 F.2d 1163, 1167 n.6 (8th Cir. 1984) (prima facie tort and slander claims were arbitrable pursuant to New York Stock Exchange rules).

[22]*Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20, 111 S. Ct. 1647, 114 L. Ed. 2d 26, 55 Fair Empl. Prac. Casa (1NA) 1116, 56 Empl. Prac. Dec, (CCH) P 40704 (1991) (involvement of statutory agency in proceeding did not bar arbitration); Shearson /American Exp., Inc. v. McMahon, 482 U.S. 220, 226, 107 S. Ct. 2332, 96 L. Ed, 2d 185, 'Fed. Sec. L. Rep. (CCH) 91 93265, R.I.C.O. Bus. Disp. Guide (CCH) P 6642 (1987) (claims brought under § 10b of the Securities Exchange Act of 1934 and under the Racketeer Influenced and Corrupt Organizations Act were arbitrable under arbitration agreement between securities broker and its customer); JLM Industries, Inc. v. Stolt-Nielsen SA, 387 F.3d 163, 2004-2 Trade Cas, (CCH) 91 74590, 2004 A.M.C. 2805 (2d Cir. 2004) (price-fixing claim under Sherman Act fell within broad arbitration clause); Patrowicz v. Transamerica HomeFirst, Inc., 359 F. Supp. 2d 140 (n. Conn. 2005) (notwithstanding claim that lender failed to provide release of mortgage upon payoff was based on requirement of Connecticut statute, arbitration clause mandated arbitration of such issues).

[23]*Anders v. Hometown Mortg. Services, Inc.*, 346 F.3d 1024 (11th Cir. 2003).

[24]*Anders v. Hometown Mortg. Services, Inc.*, 346 F.3d 1024, 1027-28 (11th Cir. 2003).

these statutory claims would be arbitrated by referring to the broad language of the arbitration clause itself.[25] Regarding the borrower's claim that the arbitration agreement was invalid because it limited the borrower's statutory remedies, the Eleventh Circuit recognized that it had previously invalidated an arbitration clause on the grounds that its remedial limitations denied the plaintiff the possibility of meaningful relief in an arbitration setting.[26] However, because the instant arbitration agreement contained a severability provision, the court concluded that the remedial limitation could be rendered invalid while the remainder of the arbitration agreement compelled the parties to arbitrate their claims.[27]

Arbitration clauses confer upon the parties a duty, to arbitrate that cannot be easily avoided. Section 4 of the FAA establishes a procedure by which a party to a dispute can obtain a district court order compelling arbitration when the other party fails, neglects, or refuses to arbitrate under the arbitration clause. Section 4 also establishes a procedure for the separate judicial, and perhaps jury, resolution of issues concerning "the making of the arbitration agreement or the failure, neglect, or refusal to perform the same."[28] However, a claim of fraud in the making

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[25] *Anders v. Hometown Mortg. Services, Inc.*, 346 F.3d 1024, 1028 (11th Cir, 2003).

[26] *Anders v. Hometown Mortg. Services, Inc.*, 346 F.3d 1024, 1030-31 (11th Cir. 2003) (citing *Paladino v. Avnet Computer Technologies, Inc.*, 134 F.3d 1054, 76 Fair Empl. Prac. Cas. (BNA) 1315, 72 Empl. Prac. Dec. (CCH) P 45222 (11th Cir. 1998). The court cited similar precedent from the Ninth Circuit, *Ingle v. Circuit City Stores, Inc.*, 328 F.3d 1165, 1179, 91 Fair Empl. Prac. Cas. (BNA) 1426, 84 Empl. Prac. Dec. (CCH) P 41386, 148 Lab. Cas. (CCH) P 59764 (9th Cir. 2003) (affirming denial of motion to compel arbitration because remedies limitation "improperly proscribes available statutory remedies" and is therefore "substantively unconscionable"), but noted that the First, Third, Seventh and Eighth Circuits each held differently, instead allowing the arbitrator to decide in the first instance whether the remedial limitations were permissible. *Anders v. Hometown Mortg. Services, Inc.*, 346 F.3d 1024, 1030-31 (11th Cir. 2003) (citing *Hawkins v. Aid Ass'n for Lutherans*, 338 F.3d 801, 807 (7th Cir. 2003); *Bob Schultz Motors, Inc. v. Kawasaki Motors Corp., U.S.A.*, 334 F.3d 721, 726 (8th Cir. 2003); *Larry's United Super, Inc. v. Werries*, 253 F.3d 1083, 1086, R.I.C.O. Bus. Disp. Guide (CCH) P 10093 (8th Cir. 2001); *MCI Telecommunications Corp. v. Matrix Communications Corp.*, 135 F.3d 27, 33 (1st Cir. 1998); *Great Western Mortg. Corp. v. Peacock*, 110 F.3d 222, 232, 73 Fair Empl. Prac. Cas. (BNA) 856, 70 Empl. Prac. Dec. (CCH) P 44638 (3d Cir. 1997)).

[27] *Anders v. Hometown Mortg. Services, Inc.*, 346 F.3d 1024, 1031-32 (11th Cir. 2003).

[28] Section 4 of the Act provides in part:

of the underlying contract does not necessarily mandate a judicial determination on the issue of fraud.[29] An arbitration clause is severable from the remainder of the contract; therefore, absent a claim of fraud in the inducement to enter into the arbitration clause itself, a mandatory arbitration clause is binding upon the parties such that a claim that a party was fraudulently induced into entering into the contract as a whole is properly left to the arbitrator, not the court.[30]

In a bankruptcy proceeding, the grant or denial of a motion for a stay pending arbitration of a dispute between a debtor and its creditor under an arbitration agreement may pit federal policies favoring the enforcement of arbitration clauses against certain competing policies

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If the making of the arbitration agreement or the failure, neglect, or refusal to perform the same be in issue, the court shall proceed 'summarily to the trial thereof. If no jury trial be demanded by the party alleged to be in default, or if the matter in dispute is within admiralty jurisdiction, the court shall hear and determine such issue. Where such an issue is raised, the party alleged to be in default may; except in cases of admiralty, on or before the return day of the notice of application, demand a jury trial of such issue, and upon such demand the court shall make an order referring the issue or issues to a jury in the manner provided by the Federal Rules of Civil Procedure, or may specially call a jury for that purpose. If the jury find that no agreement in writing for arbitration was made or that there is no default in proceeding thereunder, the proceeding shall be dismissed. If the jury find that an agreement for arbitration was made in writing and that there is a default in proceeding thereunder, the court shall make an order summarily directing the parties to proceed with the arbitration in accordance with the terms thereof.

9 U.S.C.A. § 4.

[29]See *Pierson v. Dean, Witter, Reynolds, Inc.*, 742 F.2d 334, Fed. Sec. L. Rep. (CCH) ¶ 91615 (7th Cir. 1984) ("Claims of fraud under a contract, breach of fiduciary duty, negligence, and gross negligence are not immune from arbitration under a broadly-worded valid arbitration clause.").

[30]See *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 87 S. Ct. 1801, 18 L. Ed. 2d 1270, 1969 A.M.C. 222 (1967) (distinguishing between fraud in the inducement of the entire contract and of arbitration clause alone, stating "if the claim is fraud in the inducement of the arbitration clause itself—an issue which goes to the 'making' of the agreement to arbitrate—the federal court may proceed to adjudicate it"); *Dialysis Access Center, LLC v. RMS Lifeline, Inc.*, 638 F.3d 367, 380 (1st Cir. 2011) (applying *Prima Paint*); *Spahr v. Secco*, 330 F.3d 1266, 1270 (10th Cir. 2003) ("[A]court may compel arbitration of a particular dispute under § 4 of the FAA only when satisfied that the "making" of the agreement to arbitrate is not at issue."); *Houlihan v. Offerman & Co., Inc.*, 31 F.3d 692, Fed. Sec. L. Rep. (CCH) ¶ 98351 (8th Cir. 1994) ("[A] court can consider a claim that a party was fraudulently induced to include an arbitration clause in a contract, but not a claim that an entire contract was the product of fraud.").

underlying the Bankruptcy Code.[31] Courts reason that the strong federal policy favoring arbitration under the FAA must be balanced against the Bankruptcy Code's goal of promoting the smooth functioning of the nation's commercial activities, providing the centralized resolution of purely bankruptcy issues, protecting creditors and debtors from piecemeal litigation, and upholding the bankruptcy court's authority to enforce its own orders.[32]

In proceedings that are "core" or involve causes of action that arise entirely from rights under the Bankruptcy Code, bankruptcy courts may exercise significant discretion over whether arbitration is consistent with the purposes of the Bankruptcy Code and therefore should be enforced.[33] Many courts, however, have emphasized that even in core proceedings, courts should enforce arbitration clauses unless an underlying purpose of the Bankruptcy Code would be adversely affected.[34] In contrast, a bankruptcy court has no discretion to refuse to compel arbitration of noncore proceedings or causes of action that arise from the debtor's prepetition legal or equitable rights, as opposed to the

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[31] 11 U.S.C.A. §§ 101 et seq.; see also *In re Eber*, 687 F.3d 1123, 56 Bankr. Ct. Dec. (CRR) 190, 67 Collier Bankr. Cas. 2d (MB) 1744, Bankr. L. Rep. (CCH) P 82296 (9th Cir. 2012) (affirming the district court's decision affirming the bankruptcy court's denial of a motion to compel arbitration and discussing conflicting federal policies and provisions of the Bankruptcy Code); *MBNA America Bank, N.A. v. Hill*, 436 F.3d 104, 110, Bankr. L. Rep. (CCH) P 80445 (2d Cir. 2006) ("Arbitration of [the] automatic stay claim would not necessarily jeopardize or inherently conflict with the Bankruptcy Code. We hold that the bankruptcy court did not have discretion to deny the motion to stay or dismiss the proceeding in favor of arbitration.").

[32] *In re Gandy*, 299 F.3d 489, 48 Collier Bankr. Cas. 2d (MB) 895, Bankr. L. Rep. (CCH) P 78709 (5th Cir. 2002) (noting inefficiency and defeat of the bankruptcy process from arbitrating some matters but not others); *In re Double TRL, Inc.*, 65 B.R. 993, 15 Bankr. Ct. Dec. (CRR) 190 (Bankr. E.D. N.Y. 1986) (discussing authorities explaining that bankruptcy courts have discretion to reconcile policies of the Bankruptcy Code and the FAA). Cf. *Matter of Hart Ski Mfg. Co., Inc.*, 711 F.2d 845 (8th Cir. 1983) (rejecting debtor's argument that, by filing a proof of claim, a creditor waived its contractual right to arbitrate).

[33] *In re Winstar Communications, Inc.*, 335 B.R. 556 (Bankr. D. Del. 2005) (noting distinction in court's discretion to enforce arbitration agreements in core versus non-core proceedings); see also *In re Brown*, 311 B.R. 702 (Bankr. E.D. Pa. 2004); *In re Erie Power Technologies, Inc.*, 315 B.R. 41, 43 Bankr. Ct. Dec. (CRR) 177 (Bankr. W.D. Pa. 2004); *In re Mirant Corp.*, 316 B.R. 234 (Bankr. N.D. Tex. 2004); *In re GWI, Inc.*, 269 B.R. 114, 38 Bankr. Ct. Dec. (CRR) 111, 46 Collier Bankr. Cas. 2d (MB) 1137 (Bankr. D. Del. 2001).

[34] See *In re Hagerstown Fiber Ltd. Partnership*, 277 B.R. 181 (Bankr. S.D. N.Y. 2002) (noting greater discretion to decline to enforce arbitration agreement in "substantively" core disputes than in "procedurally core" disputes); see also *In re American Classic Voyages, Co.*, 298 B.R. 222 (D. Del. 2003); *In re Phico Group, Inc.*, 304 B.R. 170 (Bankr. M.D. Pa. 2003); *In re Hicks*, 285 B.R. 317 (Bankr. W.D. Okla. 2002).

Bankruptcy Code, in the absence of a showing that Congress intended to preclude arbitration or the waiver of the judicial remedies for the statutory rights at issue.[35] In addition to the nature of the claims subject to arbitration, courts will consider, for example, whether arbitration of the claims outside of the bankruptcy proceeding would harm creditors, resolve the issues more quickly than through bankruptcy proceedings, impede the efficient and expeditious administration of the estate, inconvenience the trustee or cause other logistical problems, require allocation of estate property, or involve the interpretation of any technical provisions of the Bankruptcy Code.[36]

Thirty-five states and the District of Columbia have adopted the Uniform Arbitration Act since it was first drafted in 1955, or the Revised Uniform Arbitration Act (RUAA), which was drafted in 2000.[37] The legislatures and courts of some of those states that have not adopted the Uniform Arbitration Act have recognized the validity of such clauses or adopted alternate arbitration acts.[38] Like its federal counterpart, the Uniform Arbitration Act expresses a strong policy in favor of the recognition of arbitration agreements. Specifically, Section 1 of the Uniform Arbitration Act provides that an agreement to arbitrate an existing or future controversy is "valid, enforceable and irrevocable, save upon such grounds as exist at law or in equity for the revocation of any contract."[39] The Uniform Arbitration Act also provides a procedural mechanism by which a party to state court litigation of a dispute that is

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[35] *In re Mintze*, 434 F.3d 222 (3d Cir. 2006) ("Where an otherwise applicable arbitration clause exists, a bankruptcy court lacks the authority and discretion to deny its enforcement, unless the party opposing arbitration can establish congressional intent, under the McMahon standard, to preclude waiver of judicial remedies for the statutory rights at issue."); see also *In re Phico Group, Inc.*, 304 B.R. 170 (Bankr. M.D. Pa. 2003); *In re Crysen / Montenay Energy Co.*, 226 F.3d 160 (2d Cir. 2000); *Hays and Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 885 F.2d 1149, 19 Bankr. Ct. Dec. (CRR) 1344, Bankr. L. Rep. (CCH) P 73091, Fed. Sec. L. Rep. (CCH) P 94568 (3d Cir. 1989); *In re Merrill*, 343 B.R. 1 (Bankr. D. Me. 2006); *In re Durango Georgia Paper Co.*, 309 B.R. 394 (Bankr. S.D. Ga. 2004); *In re Cooker Restaurant Corp.*, 292 B.R. 308 (S.D. Ohio 2003); *In re APF Co.*, 264 B.R. 344 (Bankr. D. Del. 2001).

[36] See, e.g., *MBNA America Bank, N.A. v. Hill*, 436 F.3d 104, Bankr. L. Rep. (CCH) P 80445 (2d Cir. 2006); *Trefny v. Bear Stearns Securities Corp.*, 243 B.R. 300 (S.D. Tex. 1999); *In re Guy C. Long, Inc.*, 90 B.R. 99 (E.D. Pa. 1988); *In re Farmland Industries, Inc.*, 309 B.R. 14, 42 Bankr. Ct. Dec. (CRR) 263 (Bankr. W.D. Mo. 2004); *In re Erie Power Technologies, Inc.*, 315 B.R. 41, 43 Bankr. Ct. Dec. (CRR) 177 (Bankr. W.D. Pa. 2004); *In re RDM Sports Group, Inc.*, 260 B.R. 905, 37 Bankr. Ct. Dec. (CRR) 183, 46 Collier Bankr. Cas. 2d (MB) 205 (Bankr. N.D. Ga. 2001).

[37] For a listing of jurisdictions which have adopted the Uniform Arbitration Act, see Uniform Laws Annotated, Uniform Arbitration Act (2000) § 1.

[38] E.g., California Arbitration Act, California Civil Procedure Code §§ 1280 et seq.

[39] See also RUAA § 6(a).

within the scope of an arbitration agreement may obtain an order compelling arbitration. Under Section 2 of the Uniform Arbitration Act, a court shall order parties to an arbitration agreement to proceed with arbitration upon the application of one of the parties; however, if one of the parties denies the existence of an agreement to arbitrate, the court shall proceed "summarily" to determine the issue.[40] Similarly, a court may stay a pending or threatened arbitration proceeding on application by a party showing that there is no agreement to arbitrate.[41]

Subsequent sections of the Uniform Arbitration Act address the appointment of arbitrators (§ 3); the manner in which the arbitration shall be decided (§ 4); the scheduling and conduct of hearings before the arbitration panel or arbitrator (§ 5); right to counsel (§ 6); witnesses, subpoenas, and depositions (§ 7); the timing and form of any award (§ 8); and post-award matters such as judicial confirmation of an arbitration award (§ 11); vacating an award (§ 12); and modification or correction of an award (§ 13).[42]

A number of lenders today routinely insert arbitration clauses in their loan and workout agreements. The most carefully drafted clauses expressly extend to tort claims that arise between the parties and expressly exclude the lender's seizure and sale of collateral or foreclosure of its mortgage, deed of trust, or security interest from the ambit of the arbitration clause.

### § 174:57 Enforceability of forum selection clauses

The federal rule is that forum selection clauses are presumptively valid and enforceable. The leading case on the subject is *M / S Bremen v. Zapata Off-Shore Co.*,[1] in which the Supreme Court held that the forum selection clause was prima facie valid and enforceable in the

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[40]Uniform Arbitration Act § 2(a); see also RUAA § 7(a).

[41]Uniform Arbitration Act § 2(b); see also RUAA § 7(b).

[42]Similarly, the RUAA contains provisions regarding the initiation of arbitration (§ 9); consolidation of separate arbitration proceedings (§ 10); appointment of an arbitrator (§ 11); the arbitration process, including the scheduling and conduct of conferences, hearings and summary disposition of claims (§ 15); right to counsel (§ 16); witnesses, subpoenas, depositions and discovery (§ 17); the judicial enforcement of preaward rulings by an arbitrator (§ 18); the timing and issuance of an arbitration award (§ 19); the remedies, fees and expenses that may be included in an award (§ 21); post-award judicial confirmation of an arbitration award (§ 22); vacating an award (§ 23); changing, modifying or correcting an arbitration award (§§ 20, 24); and appeals of orders relating to arbitration (§ 28); among other provisions.

**[Section .58]**

[1]*M / S Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1, 92 S. Ct. 1907, 32 L. Ed. 2d 513, 1972 A.M.C. 1407 (1972).

absence of some compelling and countervailing reason making enforcement unreasonable.

In *Zapata*, a Houston-based American company (Zapata) contracted with Unterweser, a German company, to tow Zapata's drilling rig from Louisiana to Italy. The contract required that any disputes be litigated before the neutral London Court of Justice. Although the Court was at least partially motivated by policy considerations relating to the expansion of American business abroad,[2] it clearly announced the desire to break from a tradition under which such clauses were disfavored.[3] In holding that such clauses are presumptively valid, the Court outlined some of the factors that might serve to prevent enforcement of a forum selection clause, including (i) "fraud, undue influence, or overweening bargaining power";[4] (ii) "if enforcement would contravene a strong public policy of the forum in which suit is brought, whether declared by statute or by judicial decision",[5] and (iii) "if the chosen forum is seriously inconvenient for the trial of the action."[6]

With respect to inconvenience, the third listed factor, the Court noted that the party claiming such inconvenience bears a "heavy burden of proof."[7] The lower courts generally follow *Zapata* and uphold choice of

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[2] *M/S Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1, 9, 92 S. Ct. 1907, 32 L. Ed. 2d 513, 1972 A.M.C. 1407 (1972). ("The expansion of American business and industry will hardly be encouraged if, notwithstanding solemn contracts, we insist on a parochial concept that all disputes must be resolved under our laws and in our courts").

[3] *M/S Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1, 9-10, 92 S. Ct. 1907, 32 L. Ed. 2d 513, 1972 A.M.C. 1407 (1972) (noting that "[f]orum-selection clauses have historically not been favored" as "contrary to public policy" or having the effect of "oust[ing] the jurisdiction" of courts, but expressing view that the "correct doctrine" is that "such clauses are prima facie valid and should be enforced unless enforcement is shown . . . to be "unreasonable" under the circumstances").

[4] *M/S Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1, 12, 92 S. Ct. 1907, 32 L. Ed. 2d 513, 1972 A.M.C. 1407 (1972).

[5] *M/S Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1, 15, 92 S. Ct. 1907, 32 L. Ed. 2d 513, 1972 A.M.C. 1407 (1972).

[6] *M/S Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1, 16, 92 S. Ct. 1907, 32 L. Ed. 2d 513, 1972 A.M.C. 1407 (1972).

[7] *M/S Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1, 16-17, 92 S. Ct. 1907, 32 L. Ed. 2d 513, 1972 A.M.C. 1407 (1972).

forum clauses.[8] In cases involving lender liability claims, courts will examine whether such claims fall within the scope of the forum selection clauses at issue.[9] In *Mendes Junior Intern. Co. v. Banco Do Brasil, S.A.*, the court gave little weight to the party's claim that a foreign court would have difficulty applying the law based on a lack of familiarity with lender liability issues where such problems were foreseeable since the foreign court was designated in a forum selection clause and were not so insurmountable as to hamstring the litigation.[10]

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[8]See *Martinez v. Bloomberg LP*, 740 F.3d 211, 218, 29 A.D. Cas. (BNA) 308, 121 Fair Empl. Prac. Cas. (BNA) 621 (2d Cir. 2014) (discussing Zapata and noting the "presumptive enforceability of forum selection clauses"); *Huffington v. T.C. Group, LLC*, 637 F.3d 18 (1st Cir. 2011) (applying the Zapata factors and finding that the forum selection clause in parties' subscription agreement was enforceable); *Albemarle Corp. v. AstraZeneca UK Ltd.*, 628 F.3d 643, 2012 A.M.C. 1347 (4th Cir. 2010) (holding that enforcement of contract's forum selection clause was not "unreasonable" under the Zapata analysis); *Servewell Plumbing, LLC v. Federal Ins. Co.*, 439 F.3d 786, 789 (8th Cir. 2006) (upholding dismissal of subcontractor's suit against surety on general contractor's bond based on forum selection clause under subcontract); *Murphy v. Schneider National, Inc.*, 362 F.3d 1133, 1140-41 (9th Cir. 2004) (applying *Zapata* to employment contract with forum selection clause, and requiring evidentiary hearing to determine whether plaintiff would be denied day in court if clause was enforced); *AAR Intern., Inc. v. Nimelias Enterprises S.A.*, 250 F.3d 510, 525 (7th Cir. 2001) (applying *Zapata*, defendants' argument that action should be dismissed on grounds of forum non conveniens was precluded where defendants effectively conceded enforceability of forum selection clause); *Kline v. Kawai America Corp.*, 498 F. Supp. 868, 871-72 (D. Minn. 1980) (citing *Zapata* for the prima facie validity of forum selection clauses and the substantial burden which a party contesting the enforcement of such a clause must bear, and transferring case from Minnesota to California in accordance with forum selection clause under dealership agreement between the parties); cf. *Benge v. Software Galeria, Inc.*, 608 F. Supp. 601 (E.D. Mo. 1985) (court transferred lawsuit alleging, inter alia, fraud in the inducement of franchise agreement containing forum selection clause); *Jackson v. Payday Financial, LLC*, 764 F.3d 765 (7th Cir. 2014) (applying the *Zapata* standard, but finding that enforcement of the forum selection clause contained in a loan agreement would be unreasonable).

[9]E.g., *Montoya v. Financial Federal Credit, Inc.*, 872 F. Supp. 2d 1251 (D.N.M. 2012) (enforcing forum selection clause in security agreement in action between borrower against lender); *Diesel Props S.r.L. v. Greystone Business Credit II LLC*, 2008 WL 4833001 (S.D. N.Y. 2008) (analyzing the effect of forum selection clauses on each party's counterclaims, including counterclaims against secured lender, and finding that enforcing the clauses was reasonable); *U.S. Fidelity & Guar. Co. v. Petroleo Brasileiro S.A.-Petrobras*, 2001 WL 300735 (S.D. N.Y. 2001) (cross-claims, including cross-claim for lender liability, fell within scope of forum selection clause; lender liability cross-claim concerned claim that party improperly controlled construction projects and interfered with contractual performance, therefore cross-claim arose out of performance of contract).

[10]*Mendes Junior Intern. Co. v. Banco Do Brasil, S.A.*, 15 F. Supp. 2d 332, 338 (S.D. N.Y. 1998).

Even if the parties have entered into a forum selection agreement, a party may seek to transfer venue from the parties' selected forum to another forum in which venue is proper on the grounds of forum non conveniens.[11] Under the doctrine of forum non conveniens, a court may transfer venue to a district other than that which the parties have chosen in a valid forum selection clause.[12] For example, in *Plum Tree, Inc. v. Stockment*,[13] the court held that a forum selection clause, the enforcement of which is not unreasonable, does not preclude the selected forum from ordering a § 1404(a) transfer. The court stated:

> Congress set down in § 1404(a) the factors it thought should be decisive on a motion for transfer. Only one of these—the convenience of the parties—is properly within the power of the parties themselves to affect by a forum-selection clause. The other factors—the convenience of witnesses and the interest of justice—are third party or public interests that must be weighed by the District Court; they cannot be automatically out-weighed by the existence of a purely private agreement, between the parties. Such an agreement does not obviate the need for an analysis of the factors set forth in § 1404(a) and does not necessarily preclude the granting of the motion to transfer.[14]

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[11]The forum non conveniens doctrine is codified in 28 U.S.C.A. § 1404(a), which provides "[f]or the convenience of parties and witnesses, in the interest of justice, a District Court May transfer any civil action to any other district or division where it might have been brought."

[12]See, e.g., *Atlantic Marine Const. Co., Inc. v. U.S. Dist. Court for Western Dist. of Texas*, 571 U.S. 49, 134 S. Ct. 568, 574, 187 L. Ed. 2d 487, 2014 A.M.C. 1, 87 Fed. R. Serv. 3d 51 (2013) ("When a forum-selection clause points to a state or foreign forum, the clause may be enforced through the doctrine of *forum non conveniens*. Section 1404(a) is a codification of that doctrine for the subset of cases in which the transferee forum is another federal court. For all other cases, parties may still invoke the residual *forum non conveniens* doctrine.") (internal citations omitted); *Midwest Mechanical Contractors, Inc. v. Tampa Constructors, Inc.*, 659 F. Supp. 526, 531 (W.D. Mo. 1987) ("The Court is not prevented by the existence of a valid forum selection clause from considering a motion to transfer made pursuant to § 1404(a)").

[13]*Plum Tree, Inc. v. Stockment*, 488 F.2d 754, 757 (3d Cir. 1973).

[14]*Plum Tree, Inc. v. Stockment*, 488 F.2d 754, 757-758 (3d Cir. 1973).

The moving party has the burden of proving that the transfer will be to a more convenient forum.[15]

In *Wellons v. Numerica Sav. Bank, FSB*,[16] borrowers brought an action alleging that the defendant bank engaged in misrepresentation, breach of contract, breach of fiduciary duty, unfair and deceptive practices, and wrongful foreclosure. After removing the action from state court to federal court, the defendant bank sought to transfer the action from Massachusetts to New Hampshire on forum non conveniens grounds in order to consolidate it with the bank's own action for payment on the loan. Even though the borrowers' lender liability action predated the bank's action, the district court granted the bank's motion because the cause of action arose in New Hampshire (specifically, the loan was for development of New Hampshire property, closed in New Hampshire, and obtained from a New Hampshire bank), New Hampshire law would apply under the choice of law provision contained in the related promissory note, and the parties had agreed to a forum selection clause in the note designating New Hampshire.[17]

## § 174:58 Enforceability of choice-of-law provisions

Generally, the parties' choice of law will be honored unless (1) the chosen law has no substantial relationship to the parties or the transaction, or (2) application of the law of the chosen state would be contrary to a fundamental policy of a state that has a materially greater interest in the transaction.[1] Section 187 of the Restatement (Second) of Conflict of Laws provides:

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[15]See *Atlantic Marine Const. Co., Inc. v. U.S. Dist. Court for Western Dist. of Texas*, 571 U.S. 49, 63, 134 S. Ct. 568, 574, 187 L. Ed. 2d 487, 2014 A.M.C. 1, 87 Fed. R. Serv. 3d 51 (2013) ("[T]he plaintiff's choice of forum merits no weight. Rather, as the party defying the forum-selection clause, the plaintiff bears the burden of establishing that transfer to the forum for which the parties bargained is unwarranted."); *Rouse Woodstock, Inc. v. Surety Federal Sav. & Loan Ass'n*, 630 F. Supp. 1004, 1008 (N.D. Ill. 1986) (typically, a valid venue clause is treated as a defendant's waiver of his right to assert his own inconvenience on a motion to transfer); *D'Antuono v. CCH Computax Systems, Inc.*, 570 F. Supp. 708, 713 (D.R.I. 1983) ("the plaintiff, by consenting to inclusion of the forum designation in the agreements, has in effect subordinated his convenience to the bargain").

[16] *Wellons v. Numerica Sav. Bank, FSB*, 749 F. Supp. 336 (D. Mass. 1990).

[17] *Wellons v. Numerica Sav. Bank, FSB*, 749 F. Supp. 336, 337-38 (D. Mass. 1990).

**[Section .59]**

[1]See *Bank of New York v. Yugoimport*, 745 F.3d 599, 609 (2d Cir. 2014) ("New York choice-of-law rules also 'require[ ] the court to honor the parties' choice [of law provision] insofar as matters of substance are concerned, so long as fundamental policies of New York law are not thereby violated.' " (quoting *Woodling v. Garrett Corp.*, 813 F.2d 543, 551 (2d Cir. 1987))).

> (1) The law of the state chosen by the parties to govern their contractual rights and duties will be applied if the particular issue is one which the parties could have resolved by an explicit provision in their agreement directed to that issue.
>
> (a) the chosen state has no substantial relationship to the parties or the transaction and there is no other reasonable basis for the parties' choice, or
>
> (b) application of the law of the chosen state would be contrary to a fundamental policy of a state which has a materially greater interest than the chosen state in the determination of the particular issue and which, under the rule of § 188, would be the state of the applicable law in the absence of an effective choice of law by the parties.
>
> (2) The law of the state chosen by the parties to govern their contractual rights and duties will be applied, even if the particular issue is one which the parties could not have resolved by an explicit provision in their agreement directed to that issue, unless either
>
> (a) the chosen state has no substantial relationship to the parties or the transaction and there is no other reasonable basis for the parties' choice, or
>
> (b) application of the law of the chosen state would be contrary to a fundamental policy of a state which has a materially greater interest than the chosen state in the determination of the particular issue and which, under the rule of § 188, would be the state of the applicable law in the absence of an effective choice of law by the parties.
>
> (3) In the absence of a contrary indication of intention, the reference is to the local law of the state of the chosen law.[2]

Where a court honors the parties' contractual choice of law, such law will govern causes of action to enforce the express terms of the contract to which the choice of law provision applies, and even causes of action seeking to graft implied terms into the contract will be construed according to the chosen law.[3] However, normally a contractual choice of law provision sounds only in contract and will not bind parties with

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[2]Restatement Second, Conflict of Laws § 187.

[3]See, e.g., *In re Lois / USA, Inc.*, 264 B.R. 69, 97-98 (Bankr. S.D. N.Y. 2001) (having determined that contractual choice of law clause would apply to creditors' committee's action against lender, court had "little doubt" that causes of action alleging violation of implied covenant of good faith and fair dealing would be subject to chosen law).

respect to noncontractual causes of action such as tort claims.[4] Some courts have concluded that a contractual choice of law provision may control tort claims if the provision was drafted sufficiently broadly to apply to such claims.[5]

The legislature of at least one state, Texas, has enacted a statute governing the circumstances under which courts will honor a choice of law or choice of forum clause choosing the law of a state other than Texas in a contract having a significant relationship to or involving residents of the state of Texas. That statute requires that such clause be set forth "conspicuously" in a manner which a reasonable person would notice.[6]

### § 174:59 Motion to dismiss for lack of standing

Often, the shareholders of a corporate borrower assert damage claims directly against the lender when the corporation is insolvent, in bankruptcy, or otherwise no longer existing. Under such circumstances,

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[4]See *Lazard Freres & Co. v. Protective Life Ins. Co.*, 108 F.3d 1531, 1540 (2d Cir. 1997) (choice-of-law provision in the contract should not control because, under New York law, a contractual choice-of-law provision governs only a cause of action sounding in contract, not one sounding in tort); see also *Plymack v. Copley Pharmaceutical, Inc.*, 1995 WL 606272 (S,D. N.Y. 1995) (under New York law, "[a] contractual choice-of-law provision . . . does not bind the parties with respect to non-contractual causes of action"); *Rosenberg v. Pillsbury Co.*, 718 F. Supp. 1146, 1160 (S.D. N.Y. 1989) ("While [a choice-of law] provision is effective as to breach of contract claims, it does not apply to fraud claims, which sound in tort"); *Knieriemen v. Bache Halsey Stuart Shields Inc.*, 74 A.D.2d 290, 293, 427 N.Y.S.2d 10, 12-13, (1st Dep't 1980) (rejected on other grounds by, *Rescildo by Rescildo v. R.H. Macy's*, 187 A.D.2d 112, 594 N.Y.S.2d 139 (1st Dep't 1993)) ("That the parties agreed that their contract should be governed by an expressed procedure does not bind them as to causes of action sounding in tort").

[5]See *Turtur v. Rothschild Registry Intern., Inc.*, 26 F.3d 304, 310, Fed. Sec. L. Rep. (CCH) P 98241, 29 Fed. R. Serv. 3d 227 (2d Cir. 1994) (choice of law provision encompassed both contract and tort claims of securities broker against partnership and law firm); *Kroch v. Lipsay*, 97 F.3d 640, 645 (2d Cir. 1996) (stating "[u]nder New York law, in order for a choice-of-law clause to apply to claims for tort arising incident to the contract, the express language of the provision must be 'sufficiently broad' as to encompass the entire relationship between the contracting parties," and concluding that language of loan documents did not apply to lender's fraud claims against borrower); *Schuster v. Dragone Classic Motor Cars, Inc.*, 67 F. Supp. 2d 288 (S.D. N.Y. 1999) (choice of law provision would not govern claims based on fraud, unjust enrichment, breach of fiduciary duty and violation of Connecticut Unfair Trade Practices Act); *In re Lois / USA, Inc.*, 264 B.R. 69, 98-101 (Bankr. S.D. N.Y. 2001) (concluding that choice of law provision was not broad enough to encompass tort claims).

[6]Tex. Bus. & Com. Code Ann. § 35.53 (2018) (applying to contracts for "the sale, lease, exchange, or other disposition for value of goods for the price, rental, or other consideration of $50,000 or less" where contract was executed in the state and a party to the contract is an individual resident, or association or corporation created under the laws of the state or having its principal place of business in the state).

the lender's attorney should consider filing a motion to dismiss such claims. The motion to dismiss may be based on the ground that, even if the allegations of the complaint are true insofar as they allege that the lender has breached a contract with the borrower or has committed torts against the borrower, the shareholders of the corporate borrower have not suffered any damages and do not have claims against the lender.

For example, in *ITT Diversified Credit Corp. v. Kimmel*,[1] a lender brought an action against the president and sole shareholder of a corporation to enforce a guaranty of loans made to the corporation. The defendant counterclaimed, alleging that the lender had breached its agreement to continue funding the corporation and had engaged in other, commercially unreasonable behavior, which resulted in damages including lost income, decline in value of the stock of the corporation, resulting accumulation of personal liabilities, damage to reputation, emotional distress, and pain and suffering. In dismissing all of the defendant's claims, the court stated:

> Illinois courts generally do not recognize an independent cause of action for damages by a plaintiff-shareholder suing in his own behalf rather than derivatively on behalf of the injured corporation where there is no showing that the plaintiff himself has been injured in any capacity other than in com-mon with his fellow shareholders as a consequence of the wrongful actions of a third party directed towards the corporation.[2]
>
> Most courts hold that corporate shareholders suing in their individual capacity may not recover damages allegedly resulting

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[Section .60]

[1] *ITT Diversified Credit Corp. v. Kimmel*, 508 F. Supp. 140 (N.D. Ill. 1981).

[2] *ITT Diversified Credit Corp, v. Kimmel*, 508 F. Supp. 140, 144 (N.D. Ill. 1981); see also, *Twohy v. First Nat. Bank of Chicago*, 758 F.2d 1185, 1194, 1 Fed. R. Serv. 3d 296 (7th Cir. 1985) ("Under general principles of United States corporate law, as well as under Illinois law, a stockholder of a corporation has no personal or individual right of action against third persons for damages that result indirectly to the stockholder because of injury to the corporation"); *Continental Illinois Nat. Bank & Trust Co. of Chicago v. Stanley*, 585 F. Supp. 1385, 1388, 1389, (N.D. Ill. 1984) (shareholder claims dismissed under "established rule that when the injury alleged is to the corporation; the cause of action accrues to the corporation, not the stockholders").

from injury to the corporation.[3] For example, in *White v. First Nat. Bank of Pittsburgh*,[4] a shareholder/ guarantor of a corporate note sued a bank for damages sustained as a result of the bank's demand for payment of the note. The court held that the shareholder could not sue for damages allegedly sustained by the corporation, reasoning that while the principal debtor might possess a cause of action against the bank for breaching its agreement to extend a loan, the indorser of the note did not have any causes of action, and if the plaintiff could maintain an action for the same cause as the debtor, then the bank could be subject to the inequitable result of being compelled to pay twice for the same injury.[5]

A limited exception to the above rule permits a shareholder to sue in an individual capacity where it is alleged that the defendant also breached a separate and distinct duty owing to the shareholder.[6]

In certain circumstances, an individual shareholder may bring suit to enforce a derivative cause of action which belongs to the corporation

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[3]See, e.g. *Glenn K. Jackson Inc. v. Roe*, 273 F.3d 1192, 1202 n.4 (9th Cir. 2001) (noting "the well-established general rule that a stockholder of a corporation has no personal or individual right of action against third persons . . . for a wrong or injury to the corporation") (internal citations omitted); *NSM Resources Corp. v. Mountain Hardwear, Inc.*, 2010 WL 11515322, *3 (C.D. Cal. 2010) ("[T]here is a well-established general rule that a stockholder of a corporation has no personal or individual right of action against third persons for wrongs or injuries committed against the corporation."); *Alford v. Frontier Enterprises, Inc.*, 599 F.2d 483 (1st Cir. 1979) (principal shareholder of corporation could not maintain individual action against defendant gasoline supplier where defendant's dealings were with the corporation); *Judice's Sunshine Pontiac, Inc, v. General Motors Corp.*, 418 F. Supp. 1212, 1976-2 Trade Cas. (CCH) ¶ 61075 (D.N.J. 1976) (acknowledging the general rule that action to redress injuries to a corporation cannot be maintained by a stockholder in his own name but must be brought in the name of the corporation, unless the wrong is a breach of duty to the stockholder personally); *Ruth v. First Nat. Bank of New Jersey*, 410 F. Supp. 1233 (D.N.J. 1976) (if a valid claim against a bank existed on the ground that the bank had misapplied funds credited to account of corporation, the right to assert such claim would belong to the corporation and not to an individual). See, generally, 12B Fletcher Cyclopedia of the Law of Private Corporations, § 5911 (Perm. Ed.).

[4] *White v. First Nat. Bank of Pittsburgh*, 252 Pa. 205, 97 A. 403 (1916).

[5] *White v. First Nat. Bank of Pittsburgh*, 252 Pa. 205, 97 A. 403, 405 (1916).

[6]E.g., *Buschmann v. Professional Men's Ass'n*, 405 F.2d 659, 662 (7th Cir. 1969) ("It is well settled that an individual cause of action can be asserted when the wrong is both to the stockholder as an individual and to the corporation." Cf. Klapper v. Commonwealth Realty Trust, 662 F. Supp. 235, R.I.C.O. Bus. Disp. Guide (CCH) P 6703 (D. Del. 1987) (shareholders of a real estate investment trust have standing to sue for an injury to the trust under the Racketeer Influenced and Corrupt Organizations Act).

against officers, directors, or third parties.[7] As a precondition to the suit, the corporation itself must have refused to proceed with the suit after a suitable demand, unless excused by extraordinary circumstances.[8]

The bankruptcy process will present additional difficulties for shareholders attempting to assert derivative actions on behalf of the estate. Shareholder derivative suits are properly causes of action belonging to the debtor and therefore, in a bankruptcy case, are property

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[7]See *Kamen v. Kemper Financial Services, Inc.*, 500 U.S. 90, 95, 111 S. Ct 1711, 114 L. Ed, 2d 152, Fed. Sec. L. Rep. (CCH) P 95905, 19 Fed. R. Serv. 3d 401 (1991) ("The derivative form of action permits an individual shareholder to bring suit to enforce a *corporate* cause of action against officers, directors, and third parties. Devised as a suit in equity, the purpose of the derivative action was to place in the hands of the individual shareholder a means to protect the interests of the corporation from the misfeasance and malfeasance of faithless directors and managers.").

[8]*Kamen v. Kemper Financial Services, Inc.*, 500 U.S. 90, 95-96, 111 S. Ct. 1711, 114 L. Ed. 2d 152, Fed. Sec. L. Rep. (CCH) P 95905, 19 Fed. R. Serv, 3d 401 (1991) ("To prevent abuse of this remedy, however, equity courts established as a precondition for the suit that the shareholder demonstrate that the corporation itself had refused to proceed after suitable demand, unless excused by extraordinary conditions.") (internal citations omitted); see also Fed. R. Civ. P., Rule 23.1 ("The complaint [in a shareholder derivative action] shall. . . allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for the plaintiff's failure to obtain the action or for not making the effort.").

of the estate.[9] Courts have interpreted the Bankruptcy Code provisions related to property of the estate and the automatic stay as preventing individual shareholders and creditors from suing to enforce as right of action belonging to the corporation while the corporation is in bankruptcy, thereby leaving such rights to be vindicated by the

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[9]See 11 U.S.C.A § 541(a)(1) (the bankruptcy estate is comprised of "all legal or equitable interests of the debtor in property as of the com- mencement of the case."); see also *Seinfeld v. Allen*, 169 Fed. Appx. 47, 49 (2d Cir, 2006) ("The filing of a bankruptcy petition immediately alters the rights of the Corporation and the manner in which its rights can be asserted. By operation of law, upon commencement of bankruptcy proceedings the rights of action of the debtor pass to the estate.") (internal citations omitted); *Bauer v. Commerce Union Bank, Clarksville, Tennessee,* 859 F.2d 438, 441, 18 Bankr. Ct. Dec. (CRR) 765, Bankr. L. Rep. (CCH) P 72486, 12 Fed. R. Serv.3d 666 (6th Cir. 1988); *Sierra Switchboard Co. v. Westinghouse Elec. Corp.*, 789 F.2d 705, 707-10, 14 Bankr. Ct. Dec. (CRR) 709, 14 Collier Bankr. Cas. 2d (MB) 1064, Bankr. L. Rep. (CCH) P 71145 (9th Cir. 1986); *Delgado Oil Co., Inc. v. Torres*, 785 F.2d 857, 860, Bankr. L. Rep. (CCH) P 71041 (10th Cir. 1986); *Mitchell Excavators, Inc. by Mitchell v. Mitchell*, 734 F.2d 129, 131, Bankr. L. Rep. (CCH) P 69884 (2d Cir. 1984); *In re MortgageAmerica Corp.*, 714 F.2d 1266, 1276, 12 Bankr. Ct. Dec. (CRR) 151, 9 Collier Bankr. Cas. 2d (MB) 603 (5th Cir. 1983); *In re WorldCom, Inc.,* 323 B.R. 844, 857, 54 Collier Bankr. Cas. 2d (MB) 161 (Bankr. S.D. N.Y. 2005). *Cf. Caplin v. Marine Midland Grace Rust Co. of New York*, 406 U.S. 416, 92 S. Ct. 1678, 32 L. Ed. 2d 195 (1972) (Chapter X trustee lacked standing to assert direct claims of debtor's debenture holders against indenture trustee for violations of terms of indenture); *Koch Refining v. Farmers Union Cent, Exchange, Inc.*, 831 F.2d 1339, 1348-49, 18 Collier Bankr. Cas. 2d (MB) 84, Bankr. L. Rep, (CCH) P 72009 (7th Cir. 1987) (bankruptcy trustee may only maintain "general" claims, and lacks standing to bring "personal" claims of creditors, which accrue to specific creditors); *Steinberg v. Buczynski,* 40 F.3d 890, 893, 26 Bankr. Ct. Dec. (CRR) 321, 32 Collier Bankr. Cas. 2d (MB) 494, 18 Employee Benefits Cas. (BNA) 2613, Bankr. L. Rep. (CCH) P 76212 (7th Cir. 1994) (bankruptcy trustee may enforce claims of creditors that are derivative of claims of corporation against third parties, not creditors' direct claims against third parties).

bankruptcy trustee.[10] Accordingly, at the commencement of the bankruptcy case, plaintiffs in a derivative suit must demand that the trustee prosecute the suit[11] or petition the bankruptcy court to order the trustee to abandon the claim.[12] Furthermore, under a plan of reorganization, causes of action may be assigned to a reorganized entity, and upon the effective date of the plan, the plaintiffs maintaining the

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[10]E.g. *Pepper v. Litton*, 308 U.S: 295, 306-07, 60 S. Ct. 238, 84 L. Ed. 281 (1939) ("While normally that fiduciary obligation is enforceable directly by the corporation, or through a stockholder's derivative action, it is, in the event of bankruptcy of the corporation, enforceable by the trustee. For that standard of fiduciary obligation is designed for the protection of the entire community of interests in the corporation-creditors as well as stockholders."); *In re Ambac Financial Group, Inc.*, 487 Fed. Appx. 663, 665 (2d Cir. 2012) (holding that when the corporation filed for bankruptcy, the derivative claims became property of the debtor-in-possession) (citing *Mitchell Excavators, Inc. by Mitchell v. Mitchell*, 734 F.2d 129, 131, Bankr. L. Rep. (CCH) P 69884 (2d Cir. 1984))); *Torch Liquidating Trust ex rel. Bridge Associates L.L.C. v. Stockstill*, 561 F.3d 377, 386, 51 Bankr. Ct. Dec. (CRR) 68, Bankr. L. Rep. (CCH) P 81661, 167 O.G.R. 697 (5th Cir, 2009) ("By definition then, a cause of action for breach of fiduciary duty owed to the corporation that is property of the corporation at commencement of the chapter 11 case becomes property of the debtor's estate, regardless of whether outside of bankruptcy the case was more likely to be brought by the corporation directly or by a shareholder or creditor through a derivative suit."); see also *In re General Development Corp.*, 179 B.R. 335, 338, Bankr. L. Rep. (CCH) P 76470 (S.D. Fla. 1995) ("A corporation's filing for bankruptcy cuts off a shareholder's ability to bring a derivative claim"); *Schaffer ex rel. Lasersight, Inc. v. CC Investments, LDC*, 286 F. Supp, 2d 279, 51 Collier Bankr. Cas. 2d (MB) 600 (S.D. N.Y. 2003) ("This rule serves to ensure that the entire property constituting the debtor's estate remains intact and subject to management by the trustee and control of the bankruptcy court for the purposes of protecting the rights and interests of all creditors in an orderly and equitable distribution of the estate's assets").

[11]"See *Kemper v. American Broadcasting Companies, Inc.*, 365 F. Supp. 1272, 1274 (S.D. Ohio 1973) ("Where a receiver or trustee has been appointed, as here, the trustee is an indispensable party to a shareholder's derivative suit, and the shareholder must therefore make demand on the receiver or trustee and also obtain the consent and authorization of the bankruptcy or receivership court to bring suit."); see also *Matter of Consolidated Bancshares, Inc.,* 785 F.2d 1249, 1254, 14 Bankr. Ct. Dec. (CRR) 401, Bankr. L. Rep. (CCH) P 71061 (5th Cir. 1986).

[12]*See Seinfeld v. Allen*; 169 Fed. Appx. 47 (2d Cir., 2006); *Mitchell Excavators, Inc. by Mitchell v. Mitchell*, 734 F.2d 129, Bankr. L. Rep. (CCH) P 69884 (2d Cir. 1984); see also *Matter of Consolidated Bancshares, Inc.*,785 F.2d 1249, 1254, 14 Bankr. Ct. Dec. (CRR) 401, Bankr. L. Rep. (CCH) P 71061 (5th Cir. 1986) ("The lawsuit was never abandoned to the Grubbs group to prosecute. Under similar circumstances, such lawsuits have been dismissed"); *In re Ira Haupt & Co.,* 274 F. Supp. 1007, 1012 (S.D. N.Y. 1967) (noting that plaintiffs in a derivative action do not have a right to maintain the suit unless either the court relinquishes its jurisdiction or the suit is abandoned by the trustee).

derivative suit may be prevented from proceeding with the action.[13] Courts have held that bankruptcy courts have the power to grant standing to the creditors' committee to bring a derivative action in the name of the debtor.[14] Standing will generally be conferred where the creditors' committee can show: (i) the debtor or trustee unjustifiably failed to bring the derivative action; (ii) the committee advances colorable claims that would support recovery; (iii) the lawsuit is likely to benefit the estate; (iv) granting standing to the committee is preferable to appointing a trustee to raise the claims; and (v) the prospective likelihood of success and recovery justifies the anticipated delay and expense to the estate.[15]

## § 174:60 Motion to dismiss tort claims

Tort claims may be vulnerable to a motion to dismiss where the plaintiff complains of a breach of either a loan commitment or a loan agreement and, in effect, alleges that the facts giving rise to the alleged breach of contract also amount to a tort. If the plaintiff alleges, for instance, negligence or breach of fiduciary duty, a finding of liability would permit recovery of not only compensatory damages but also punitive damages. However, as a general rule, the violation of a contract will not furnish a basis for liability in tort and for the recovery of punitive damages.

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[13] *In re WorldCom, Inc.,* 323 B.R. 844, 857, 54 Collier Bankr. Cas. 2d (MB) 161 (Bankr. S.D. N.Y. 2005) ("[A]ny such action commenced was property of the estate and upon the effective date became property of the reorganized Debtors. As such the Debtors may only maintain the action, therefore, the Plan Injunction prevents [the plaintiff] from proceeding with such action.").

[14] *See In re STN Enterprises*, 779 F.2d 901, 904, Bankr. L. Rep. (CCH) P 70913 (2d Cir. 1985) (holding that creditors' committees have an implied, qualified right, when approved by the bankruptcy court to bring adversary proceedings in the name of the debtor when the trustee or the debtor failed to do so without justification and citing cases and find that "the majority rule permits recovery by creditors of an insolvent corporation for mismanagement as if the corporation itself were plaintiff"); see also *In re Adelphia Communications Corp.*, 544 F.3d 420, 423-24, 50 Bankr. Ct. Dec. (CRR) 166, 60 Collier Bankr. Cas. 2d (MB) 453, Bankr. L. Rep. (CCH) P 81328 (2d Cir. 2008) (noting that the Second Circuit "has recognized an "implied, but qualified" right under 11 U.S.C. §§ 1103(c)(5) and 1109(b) for an unsecured creditors' committee to assert claims where the trustee or debtor-in-possession unjustifiably failed to bring suit or abused its discretion in not suing on colorable claims likely to benefit the reorganization estate"); *In re Racing Services, Inc.,* 540 F.3d 892, 902, 50 Bankr. Ct. Dec. (CRR) 135 (8th Cir. 2008) ("[A]creditor may proceed derivatively when the trustee (or debtor-in-possession) consents (or does not formally oppose) the creditor's suit.").

[15] See *In re STN Enterprises*, 779 F.2d 901, 905-06, Bankr. L. Rep. (CCH) P 70913 (2d Cir. 1985) (discussing the factors but noting that the bankruptcy court need not undertake a mini-trial is determining whether conferring standing on the creditors' committee is appropriate).

For example, in Ronco, Inc. v. Plastics, Inc.,[1] the court dismissed negligence and fraud claims on the basis that the law of contract was the appropriate vehicle for relief, stating:

> Plaintiffs negligence claim. . . is meritless. Under Illinois law, which all parties agree controls in this diversity case, one who suffers purely economic losses from an alleged breach of contract may not maintain a separate cause of action sounding in tort. The law of contract, not tort, is the appropriate vehicle for relief.[2]

Before tort liability will attach, a separate obligation or duty from the contractual obligation must arise.[3] Some states allow tort liability to flow from a breach of contract only when a special relationship exists, such as between an insurance company and an insured or between employer and employee.[4]

### § 174:61 Motion to dismiss for failure to state a claim

In addition to filing a motion to dismiss tort claims which, in essence, constitute recast contract claims, lender's counsel should consider possible bases for attacking the specific claims that have been asserted by the plaintiff borrower. These bases may derive from the plaintiff's failure to properly plead the elements of the alleged cause of action because the factual allegations of the alleged cause of action do not state a claim or because the undisputed facts belie the existence of the alleged

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[Section .61]

[1]Ronco, Inc. v. Plastics, Inc., 539 F. Supp. 391 (N.D. Ill. 1982).

[2]*Ronco, Inc. v. Plastics, Inc.,* 539 F. Supp. 391, 394-95 n.4 (N.D. Ill. 1982); see also *ARH Distributors, Inc. v. ITT Commercial Finance Corp*., 1987 WL 17834 (N.D. Ill. 1987) (holding that a case for negligent misrepresentation requires "a showing of some extracontractual duty" and that a "plaintiff" ] cannot convert [a] contract claim into a tort action without pointing to a specific, objective manifestation[ ] of fraudulent intent—a scheme or device") (internal citation omitted).

[3]*John Deere Co. of St. Louis v. Short,* 378 S.W.2d 496, 503 (Mo. 1964) (adding that since "there was no duty independent of contract to make loans, . . . a breach of contract to make loans would not constitute a tort").

[4]See, e.g., *Seaman's Direct Buying Service, Inc. v. Standard Oil Co.*, 36 Cal, 3d 752, 777, 206 Cal. Rptr. 354, 686 P.2d 1158, 39 U.C.C. Rep. Serv. 46 (1984) (overruled on other grounds by, Freeman & Mills, Inc. v. Belcher Oil Co., 11 Cal. 4th 85, 44 Cal. Rptr. 2d 420, 900 P.2d 669 (1995)) (abuse of the "special relationship" between insured and insurer warrants imposition of tort liability); *First Midwest Bank v. AMP of Illinois, LLC*, 2012 IL App (1st) 102917-U, 2012 WL 6951946, *5 (Ill. App. Ct. 1st Dist. 2012) (unpublished opinion)) (noting that "no Illinois case or statute supports a cause of action for [tortious] bad-faith dealing outside the areas of insurance and employment law") (citing *Koehler v. First Nat. Bank of Louisville*, 232 Ill. App. 3d 679, 174 Ill. Dec. 49, 597 N.E.2d 1261, 1264 (5th Dist. 1992)).

[Section .63]

claim. In the latter case, because the motion would require the lender to direct the court's attention to matters outside the pleadings, the appropriate motion would be a motion for summary judgment or partial summary judgment.

### § 174:62 Collateral estoppel/res judicata

A lender should consider filing a motion to dismiss or for summary judgment on the ground that the claim is barred by the doctrine of *res judicata*. Federal courts have barred the assertion of lender liability claims where prior adjudications in bankruptcy court had established the validity of the debt owed to the lenders. For example, in *Eubanks v. F.D.I.C.*[1] the Fifth Circuit affirmed the district court's dismissal of the borrower's lender liability claims on the grounds of res judicata. Pointing to alleged bank misrepresentations, the borrower alleged fraud, breach of fiduciary duty, breach of contract, and violation of the Louisiana Blue Sky Law. The court dismissed the borrower's claims because the plaintiff failed to raise them prior to confirmation of the plaintiffs earlier bankruptcy reorganization, Reasoning that the elements of *res judicata* had been met,[2] the court held that the confirmed Chapter 11 plan allowing the lender's claim served as an absolute bar to the later lender liability claims by the borrower and his wife.[3]

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[1] *Eubanks v. F.D.I.C.*; 977 F.2d 166, 23 Bankr. Ct. Dec. (CRR) 1015 (5th Cir. 1992).

[2] *Eubanks v. F.D.I.C.* 977 F.2d 166, 174, 23 Bankr., Ct. Dec. (CRR) 1015 (5th Cir, 1992) (elements of *res judicata* satisfied in that: (1) parties were identical in the two actions; (2) the final order confirming the Chapter 11 plan was entered by a court of competent jurisdiction; (3) there was a final judgment on the merits; and (4) the new litigation involved the same causes of action).

[3] See also *Sanders Confectionery Products, Inc, v. Heller Financial, Inc.,* 973 F.2d 474, Bankr. L. Rep. (CCH) ¶ 74917, Fed. Sec. L. Rep. (CCH) ¶ 96966, R.I.C.O. Bus. Disp. Guide (CCH) 8063 (6th Cir. 1992) (if lender liability claims are not asserted in a Chapter 11 case, the order confirming the plan will constitute an absolute bar unless the plan expressly preserves the claim); *Oneida Motor Freight v. United Jersey Bank*, 75 B.R. 235 (D.N.J. 1987), order aff'd, 848 F.2d 414, 17 Bankr. Ct. Dec. (CRR) 1272, Bankr. L. Rep. (CCH) ¶ 72329 (3d Cir. 1988) (prior bankruptcy court determinations establishing validity of bank's claim in automatic stay context precluded debtor from litigating breach of contract and fraud claim against bank in subsequent proceeding); *In re Futter Lumber Corp.*, 473 B.R.20, 29 (E.D. N.Y, 2012) (affirming the lower court's holding that the debtor's "failure to raise" the lender liability claims during the bankruptcy hearing barred them from litigating in a separate proceeding"); *Sure-Snap Corp. v. State Street Bank and Trust Co.*, 948 F.2d 869, Bankr. L. Rep. (CCH) ¶ 74330 (2d Cir. 1991) (holding that a "confirmed plan of reorganization constitutes a final judgment on the merits that is entitled to preclusive effect under the doctrine of *res judicata*"); *Matter of Howe*, 913 F.2d 1138, Bankr. L. Rep. (CCH) ¶ 73640 (5th Cir. 1990) (affirming the lower court's ruling that lender liability claims were barred on *res judicata* grounds).

Similarly, in *Continental Illinois Nat. Bank and Trust Co. of Chicago v. Windham*,[4] a lender asserted the defenses of judicial estoppel *and res judicata* based on a guarantor's prior admissions concerning his corporation's underlying obligation and the entry of an order for relief recognizing the validity of the lender's claim in an involuntary bankruptcy case involving the corporation. The lender had been a petitioning creditor in the prior involuntary bankruptcy. The court held that, under Code § 303(b), the bankruptcy court's order for relief necessarily entailed a finding that the claims of the petitioning creditors were not subject to a bona fide dispute. Because the guarantor was a principal and thus in privity with the debtor corporation, the bankruptcy court's order for relief precluded the guarantor from relitigating the validity of the lender's claim. Accordingly, the court dismissed the guarantor's 23 counterclaims.

## § 174:63 Waiver of claims

A lender may file a motion to dismiss or for summary judgment on the ground that the borrower has waived or released its lender liability claim. Often as a part of a loan extension, forbearance, or workout agreement, the lender requires the borrower to release any existing, known or unknown, lender liability claim that the borrower may have against the lender. In order to be enforceable, such waivers must evidence a voluntary and knowing intention to surrender legal rights.[1] Under the laws of at least one state, California, a general release does not extend to claims of which the releasing party is unaware at the time

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[4] *Continental Illinois Nat. Bank and Trust Co. of Chicago v. Windham*, 668 F. Supp. 678 (E.D. Tex. 1987).

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[1] See, e.g., *Fanney v. Trigon Ins. Co.*, 11 F. Supp. 2d 829, 831 (E.D. Va. 1998) ("The law is well-settled that a waiver is the voluntary and intentional relinquishment of a known right."); *BancBoston Mortg. Corp. v, Harbor Estates Partnership*, 768 F. Supp. 170 (W.D. N.C. 1991) (holding that a borrower's waiver of defenses, setoffs and counterclaims is enforceable when it is supported by valuable consideration and it is evident that the borrower knowingly surrendered these rights); *Berardi v. Meadowbrook Mall Co.*, 212 W. Va. 377, 383-84, 672 S.E.2d 900 (2002) (a release of prior conduct contained in a settlement agreement was not procured under economic duress when the borrower was represented by counsel, had ample time to consider the release, and the borrower accepted benefits of the settlement after the alleged duress had passed) (citing *Freedlander; Inc., The Mortg. People v. NCNB Nat. Bank of North Carolina*, 706 F. Supp. 1211 (E.D. Va. 1988), aff'd, 921 F.2d 272 (4th Cir. 1990)); *Cumberland & Ohio Co. of Texas, Inc. v. First American Nat. Bank*, 936 F.2d 846 (6th Cir. 1991) (reversing a $6 million jury verdict in favor of borrower where the borrower's failure to repudiate the provision until five years after it was executed indicated an absence of economic duress in signing the waiver); *Parrish v. United Bank of Arizona*, 164 Ariz. 18, 790 P.2d 304 (Ct. App. Div. 2 1990) (release in workout documents may be invalid where lender fails to disclose material facts to borrower).

of executing the release, unless the release expressly covers such unknown claims.[2] In preparing a defense of a lender liability case, counsel for the lender should review all applicable documents and consider all relevant facts to determine if there has been an express or implied waiver by the borrower of any claims it may otherwise have against the lender.

### § 174:64 Motion to strike jury demand

A lender may move to strike a jury demand on grounds of untimeliness. Pursuant to Federal Rules of Civil Procedure, Rule 38(b):

> On any issue triable of right by a jury, a party may demand a jury trial by:
>
> (1) serving the other parties with a written demand—which may be included in a pleading—no later than 14 days after the last pleading directed to the issue is served; and
> (2) filing the demand in accordance with Rule 5(d).[1]

As a general rule, courts have recognized the right of a party contractually to waive the right to a jury trial in a civil case.[2] Contractual jury waiver provisions are neither illegal nor contrary to public policy.[3] A court will uphold a contractual waiver of the right to jury trial if the waiver is voluntarily, intelligently, and knowingly made.

For example, in N. Feldman & Son, Ltd. v. Checker Motors Corp.,[4] the plaintiff, an importer of equipment, brought an action against Checker, a manufacturer of taxicabs, and GM, a manufacturer of diesel engines, alleging breach of contract, breach of express and implied warranties, fraud, negligence, strict liability in tort, and conspiracy. Checker moved to strike the plaintiffs demand for a jury trial, contending that the plaintiff had waived a jury trial by executing an

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[2]Cal. Civ. Code § 1542.

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[1]Fed. R. Civ. P. 38(b).

[2]E.g., *Seligson v. Plum Tree, Inc.*, 361 F. Supp. 748, 758, 179 U.S.P.Q. 667, 1973-2 Trade Cas. (CCH) ¶ 74644, 17 Fed. R. Serv. 2d 793 (E.D. Pa. 1973).

[3]*L & R Realty v. Connecticut Nat. Bank*, 246 Conn. 1, 9, 715 A.2d 748, 752 (1998) (holding that the Connecticut state constitution, like the United State Constitution, has been "interpreted to permit waiver of the fundamental right to a jury trial, in advance of litigation, by agreement among the parties") (citing *Smith-Johnson Motor Corp. v. Hoffman Motors Corp.*, 411 F. Supp. 670, 677 (E.D. Va. 1975)).

[4]*N. Feldman & Son, Ltd, v. Checker Motors Corp.*, 572 F. Supp. 310, 313, 37 Fed. R. Serv. 2d 1013, 37 U.C.C. Rep. Serv. 730 (S.D. N.Y. 1983).

agreement that contained a provision calling for resolution of disputes "by a judge sitting without a jury," The court granted Checker's motion, based upon the plaintiff's voluntary and informed consent to a jury trial waiver. The court noted that the waiver provision was clearly visible and located directly above the signatures of the contracting parties, the plaintiff did not fit into the category of an individual with "no real choice" but to sign the waiver provision, and the plaintiff had previously entered into a similar agreement with Checker that contained the same jury waiver provision. Courts have also viewed arbitration clauses as essentially a waiver of party's right to a jury trial, and most courts have found that the heightened "knowing and voluntary" standard need not apply for a waiver of jury trial rights to be valid with respect to arbitration agreements.[5]

Similarly, the Fourth Circuit upheld a contractual jury waiver in a commercial setting. In *Leasing Service Corp. v. Crane*,[6] the district court granted the plaintiffs motion to strike the defendants' demand for jury trial, holding that the defendants had waived their right to jury trial by executing an equipment lease agreement. The Fourth Circuit affirmed, stating that a right to jury trial can be knowingly and intentionally waived by contract, even though the jury waiver provision was situated on the reverse side of a two-page, standardized, fine-print contract provided by the plaintiff and was buried in the middle of the paragraph instead of being set off in a separate paragraph of its own. The Fourth Circuit enforced the jury waiver, noting that the lease agreement was only two pages long and that the "parties were not manifestly unequal in bargaining positions."

However, courts have been reluctant to enforce such waivers in circumstances in which the waiver is not knowing and voluntary, or when the parties have substantially unequal bargaining power. For example, in *National Equipment Rental, Ltd. v. Hendrix*,[7] the Second Circuit affirmed a judgment on a jury verdict dismissing a lawsuit by an equipment lessor to collect the balance due under an equipment lease. The Second Circuit rejected the lessor's claim that because of a clause in the lease under which the lessee waived his right to jury trial, the district court improperly granted the lessee's demand for a jury trial. In

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[5]See Norton Bankruptcy Law and Practice 3d § .57.

[6]*Leasing Service Corp. v. Crane,* 804 F.2d 828, 3 U.C.C. Rep. Serv. 2d 329 (4th Cir. 1986).

[7]*National Equipment Rental, Ltd. v. Hendrix*, 565 F.2d 255, 24 Fed. R. Serv. 2d 1162 (2d Cir. 1977).

doing so, the court focused on the inconspicuousness of the waiver and the inequality of bargaining power of the parties.[8]

The legislative bodies of a number of states have enacted statutes governing the right of a party to waive his or her right to trial by jury and the manner in which such waiver must be exercised. Hence, a lawyer seeking to insert an express waiver of the right to a jury trial or an arbitration clause into a loan agreement or to enforce such a provision should examine applicable state law.

In the bankruptcy context, bankruptcy courts are specifically authorized to conduct jury trials under certain circumstances,[9] and the parties' right to a jury trial, as preserved under Rule 38(a) of the Federal Rules of Civil Procedure, is incorporated in bankruptcy proceedings under Rule 9015 of the Federal Rules of Bankruptcy Procedure. The right to a jury trial is waived if demand is not made in accordance with the time limits set forth under Rule 38(b) of the Federal Rules of Civil Procedure.

A nondebtor party may waive its right to a jury trial in a bankruptcy proceeding in a number of contexts. The filing of a proof of claim may constitute a waiver of jury trial rights over issues related to the claims allowance process, including actions for the recovery of a preference or

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[8] See also *K.M.C. Co., Inc. v. Irving Trust Co.*, 757 F.2d 752, 1 Fed. R. Serv. 3d 1095, 92 A.L.R. Fed. 661 (6th Cir. 1985) (contractual waiver of a right to a jury trial was not knowing and voluntary, and hence invalid, where president of the borrower testified that he was told by a representative of the lender, prior to signing the loan agreement, that the jury waiver provision would not be enforced absent fraud).

[9] 28 U.S.C.A. § 157 (e) provides:

> If the right to a jury trial applies in a proceeding that may be heard under this section by a bankruptcy judge, the bankruptcy judge may conduct the jury trial if specially designated to exercise such jurisdiction by the district court and with the express consent of all the parties.

fraudulent conveyance.[10] Generally, by filing a counterclaim, whether permissive or compulsory, a defendant invokes the equitable jurisdiction

[10] *See Langenkamp v. Culp*, 498 U.S. 42, 111 S. Ct. 330, 112 L. Ed. 2d 343, 20 Bankr. Ct. Dec. (CRR) 1953, 23 Collier Bankr. Cas. 2d (MB) 973, Bankr. L. Rep. (CCH) P 73668, 18 Fed. R. Serv. 3d 586 (1990) (by filing claims against the estate, creditors brought themselves within the equitable jurisdiction of the bankruptcy court, thereby forgoing right to a jury trial in preference action); *Katchen v. Lundy*, 382 U.S. 323, 327, 86 S. Ct. 467, 15 L. Ed. 2d 391, 9 Fed. R. Serv. 2d 38A.2, Case 6 (1966) (creditor, who had filed proof of claim, had no right to a jury trial in suit for recovery of preference); *In re EXDS, Inc.*, 301 B.R. 436, 42 Bankr. Ct. Dec. (CRR) 41 (Bankr. D. Del. 2003) (filing of proof of claim waives creditor's jury trial right on preference claims); see also *In re Ogden New York Services, Inc.*, 312 B.R. 729, 733, 43 Bankr. Ct. Dec. (CRR) 124, 52 Collier Bankr. Cas. 2d (MB) 1165 (S.D. N.Y. 2004) (although, in general, a party forsakes it right to a jury trial by filing a proof of claim, it is not clear that party's filing of "protective" proof of claim implicated the claims-allowance process or could affect the hierarchy of claims to constitute waiver of jury trial right); *In re Commercial Financial Services, Inc.*, 252 B.R. 516, 36 Bankr. Ct. Dec. (CRR) 181, 44 Collier Bankr. Cas. 2d (MB) 1272, 16 I.E.R. Cas. (BNA) 1220 (Bankr. N.D. Okla. 2000) (claim for administrative expense constituted a request for distribution of estate, thereby waiving right to a jury trial in separate adversary proceeding); cf. *Granfinanciera*, *S.A. v. Nordberg*, 492 U.S. 33, 109 S. Ct. 2782, 106 L. Ed, 2d 26, 19 Bankr., Ct. Dec. (CRR) 493, 20 Collier Bankr. Cas. 2d (MB) 1216, Bankr. L. Rep. (CCH) P 72855, 18 Fed. R. Serv. 3d 435 (1989) (creditor who did not file proof of claim retained right to a jury trial in fraudulent conveyance action); see also *Executive Benefits Ins. Agency v. Arkison*, 573 U.S. 25, 28, 134 S. Ct. 2165, 2168, 189 L. Ed. 2d 83, 59 Bankr. Ct. Dec. (CRR) 160, 71 Collier Bankr. Cas, 2d (MB) 875, Bankr. L. Rep. (CCH) P 82642 (2014) holding that *Stern v. Marshall*, 564 U.S. 462, 131 S. Ct. 2594, 180 L. Ed. 2d 475, 55 Bankr. Ct. Dec. (CRR) 1, 65 Collier Bankr. Cas. 2d (MB) 827, Bankr. L. Rep. (CCH) P 82032 (2011), outside of Constitutional issues relating to final judgments, "did not, however, decide how bankruptcy or district courts should proceed when a 'Stern claim is identified"); *U.S. Bank Nat. Ass'n v. Verizon Communications, Inc.*, 761 F.36 409, 425, 59 Bankr. Gt. Dec. (URR) 235 (5th Cir. 2014), as revised, (Sept. 2, 2014) ("In light of the Supreme Court's recent clarification of Stern [in *Executive Benefits*), we reject the Trustee's argument that Stern requires that its fraudulent transfer claim against Verizon be heard by a jury.")

of the bankruptcy court and may thereby waive its right to a jury trial.[11] Bankruptcy courts may also enforce agreements to waive jury trials where the waiver was made knowingly and voluntarily, and not the product of coercion or undue influence.[12]

There is some disagreement among the courts regarding a debtor waiving its right to jury trial. Some courts have held that a debtor waives its right to jury trial simply by filing a voluntary petition for relief under the Bankruptcy Code.[13] Other courts have concluded that a debtor lacks a right to jury trial in lender liability actions which arise out of the same facts as a creditor's proof of claim.[14] *In Germain v.*

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[11] *See In re Endeavour Highrise L.P.*, 425 B.R. 402, 413, 63 A.L.R. Fed. 2d 631 (Bankr. S.D. Tex. 2010) (finding that a party that had filed a counterclaim had waived its right to a jury trial, noting that "many courts have held that a counterclaim against the estate (or property of the estate) serves as the functional equivalent of a proof of claim, and therefore that filing a counterclaim constitutes a waiver of the right to a jury trial and consent to the equity jurisdiction of the bankruptcy court"); *Roberds, Inc. v. Palliser Furniture*, 291 B.R. 102, 49 Collier Bankr. Cas. 2d (MB) 1387 (S.D. Ohio 2003) (filing of answer and counterclaim in debtor's preference action constituted waiver of jury trial right without regard to compulsory or permissive nature of counterclaim or the fact that counterclaim was for postpetition administrative expense); *In re Price*, 2006 WL 2038679 (Bankr. M.D. Ala. 2006) (compulsory counterclaim that creditor held lien in the event that transfers were avoided constituted waiver of jury trial); *In re Allied Companies, Inc.*, 137 B.R. 919, 925 (S.D. Ind. 1991) (defendant invoked equitable powers of bankruptcy court by filing a counterclaim against the plaintiff-debtor seeking reclamation, priority claim or lien and thereby lost its right to a jury trial); *Bayless v. Crabtree Through Adams*, 108 B.R. 299, 29 Fed. R. Eivid. Serv. 764 (W.D. Okla. 1989), aff'd, 930 F.2d 32 (10th Cir, 1991) (same); but see *Beard v. Braunstein*, 914 F.2d 434, 23 Collier Bankr. Cas. 2d (MB) 1247, Bankr. L. Rep. (CCH) P 73625 (3d Cir. 1990) (filing compulsory counterclaim does not waive right to jury trial); *Control Center; L.L.C. v. Lauer*, 288 B.R. 269 (M.D. Fla. 2002) (right to jury trial not waived by asserting compulsory counterclaim in action alleging misappropriation of debtor's trade secrets and conversion where counterclaim was in nature of personal injury tort claim that could not be subjected to a bankruptcy court's equitable claims-allowance process).

[12] See, e.g., *In re MarketXT Holdings Corp.*, 336 B.R, 39, 61-62 (Bankr. S.D. N.Y. 2006); *In re Charlotte Commercial Group, Inc.*, 288 B. R. 715, 720 (Bankr. M.D. N.C. 2003); *In re Southern Indust. Mechanical Corp.*, 266 B.R. 827, 46 Collier Bankr. Cas. 2d (MB) 1686 (W.D. Tenn. 2001).

[13] *Matter of Hallahan*, 936 F.2d 1496, 1505-06, Bankr. L. Rep. (CCH) P 74066 (7th Cir. 1991) (if a creditor loses any right to a jury trial by submitting its claim to the court, then "debtors who initially choose to invoke the bankruptcy court's jurisdiction to seek protection from their creditors cannot be endowed with any stronger right").

[14] See, e.g., *In re Charlotte Commercial Group, Inc.*, 288 B.R. 715, 718-20 (Bankr. M.D. N.C. 2003); *In re WSC, Inc.*, 286 B.R. 321, 331-32, 40 Bankr. Ct. Dec. (CRR) 155, 49 Collier Bankr. Cas. 2d (MB) 813 (Bankr. M.D. Tenn. 2002); *Matter of Romar Intern. Georgia, Inc.*, 198 B.R. 407, 410-11, 29 Bankr. Ct. Dec. (CRR) 484 (Bankr. M.D. Ga. 1996); *In re Auto Imports, Inc.*, 162 B.R. 70, 71-72 (Bankr. D. N.H. 1993).

*Connecticut Nat. Bank*,[15] however, the Second Circuit held that a chapter 7 trustee retained the right to a jury trial in a lender liability action against a bank despite the fact that the bank had filed a proof of claim in the bankruptcy case (and therefore had no right to jury trial on its proof of claim).[16]

### § 174:65 Summary judgment considerations

Bank counsel may be inclined to seek entry of a partial summary judgment on the bank's claim under its promissory note or credit agreement. However, where substantial lender liability counterclaims exist and cannot be disposed of upon summary judgment, it may be inadvisable for the bank to seek summary judgment on its affirmative claims. If the bank succeeds, it may lose the opportunity to open and close at trial and, perhaps more importantly, to put into evidence its good acts and resulting damages. Furthermore, a lender should consider filing a motion in limine to preclude offers of prejudicial and clearly irrelevant facts. Facts that bank counsel may want to exclude include the (1) size of the bank, (2) ownership of the bank, (3) status of the loan, and (4) termination of bank employee(s).

## B. POSTTRIAL MOTIONS

### § 174:66 Motion for directed verdict

A court may grant a motion for directed verdict because damages are too speculative. In the past, a new business or a business that had been experiencing losses could not recover damages for lost profits. Courts would not allow parties to go to the jury on lost profits claims where the very fact, as distinguished from the amount, of such lost profits was speculative. This has developed into a rule of substantive contract law rather than a mere evidentiary matter.[1]

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[15] *Germain v. Connecticut Nat. Bank*, 988 F.2d 1323, 24 Bankr. Ct, Dec. (CRR) 183, 28 Collier Bankr. Cas. 2d (MB) 947, Bankr. L. Rep. (CCH) P 75191 (2d Cir, 1993).

[16] *Germain v. Connecticut Nat. Bank*, 988 F.2d 1323, 1327-32, 24 Bankr. Ct. Dec. (CRR) 183, 28 Collier Bankr. Cas. 2d (MB) 947, Bankr. L. Rep. (CCH) P 76191 (2d Cir. 1993).

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[1] See, e.g., *Truscott v. Peterson*, 78 N.D. 498, 518, 50 N.W.2d 245, 257 (1951) (stating that interrupted business must be "established" and "successfully conducted for such a length of time and had such a trade established that the profits thereof were reasonably ascertainable," and that "prospective profits of a new business or enterprise are generally regarded as being too remote, contingent, and speculative to meet the legal standard of reasonable certainty applicable in determining the elements of recoverable damages in an action for breach of contract or for a tort").

Recently, however, some courts have treated proof of lost profits as an evidentiary matter and have permitted a business to recover such damages notwithstanding an unprofitable history.[2] Generally, they have permitted recovery of lost profits by a start-up or historically unprofitable company where there is a sound evidentiary basis for assessing damages. For example, expert testimony may adequately indicate that a "start-up" period of loss was the foundation for a profitable operation.[3] Damages may also be awarded where there is an evidentiary basis for finding that, although the plaintiff may not have been profitable in general, the breached contract would have produced a profit.[4]

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[2]*Handi Caddy, Inc. v. American, Home Products Corp.*, 557 F.2d 136, 139 (8th Cir. 1977) ("It does not follow. . . that a so-called 'new' business can never recover lost profits as an item of damages for breach of contract. In the final analysis, the question is primarily a problem of proof. Each case must rest upon the evidence adduced and it is for the trial judge in the first instance to determine whether the complaining party has produced the quantum and quality of evidence sufficient to submit the issue to a jury.").

[3]See, e.g., *Ice Corp. v. Hamilton Sundstrand Corp.*, 615 F. Supp. 2d 1256, 1261 (D. Kan. 2009) (expert's calculation of lost profits was reasonable on misappropriation claim under Kansas Uniform Trade Secrets Act); *In re Knickerbocker*, 827 F.2d 281, 288 (8th Cir. 1987) (stating that while "data regarding a plaintiffs actual performance" is not always required, the decision as to whether expert testimony to calculate damages may be allowed rests in the "sound discretion of the trial court") (citing *Lakota Girl Scout Council, Inc. v. Havey Fund-Raising Management, Inc.*, 519 F.2d 634, 640 (8th Cir. 1975) (upholding jury's award of lost profits for breach of fund-raising contract based on expert testimony regarding similar fund-raising in other areas)); *Dean W. Knight & Sons, Inc. v. First Western Bank & Trust Co.*, 84 Cal. App. 3d 560, 568, 148 Cal. Rptr. 767 (2d Dist. 1978) ("The fact that the development had not yet generated a profit at the time that First Western committed its fraud does not of itself prevent recovery of damages for loss of profit so long as there is an evidentiary basis establishing that the loss period was a foundation for, profitable operation."); *Vickers v. Wichita State University, Wichita*, 213 Kan. 614, 518 P.2d 512, 517 (1974) (business techniques were available to calculate profits with "reasonable certainty to justify a contractual relationship," and it would be manifestly unjust to permit contractor to breach contract, and thereby take advantage of, new business in promotional period without liability just because operator could not show a profit during period).

[4]See *Stark v. Shaw*, 155 Cal, App. 2d 171, 188, 317 P.2d 182 (2d Dist. 1957) (stating that issue is not "whether the company has made profits in the past, or whether . . . it will produce profits in the future; rather, the issue to be determined is whether the company was reasonably certain to make a profit under *this particular contract*."); *Retama Manor Nursing Centers, Inc, v. Cole*, 582 S.W.2d 196, 202 (Tex. Civ. App. Corpus Christi 1979), writ refused n.r.e. (stating that since "a single contract covering one transaction in which both parties were committed to a definite price in exchange for certain materials and service" was involved, profits were "not nearly as speculative. . . [and] lost profits can be measured by the difference between the contract price and what it would have cost the contractor to perform the contract in accordance with the plans and specifications.").

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If you have any questions or comments regarding this alert, or would like to discuss the issues raise in this alert, please feel free to contact us at Noble Law PLLC.

**Kenneth Noble**

Noble Law PLLC
460 West 42nd Street, Suite 53K
New York, New York 10036-6805
+1 917 689 5897
knoble@noblepllc.com