PUBLICATION

Good Faith, Fair Dealing and Moral What? Beyond the Four Corners of Your Documents

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Lenders are used to the adage that "those who have the gold make the rules." In commercial lending transactions, these "rules" are usually expressed in the parties' written contract, and courts have generally been reluctant to go beyond the parties' expressed agreement when refereeing commercial disputes— ode to freedom of contract.

Beginning in the 1980's, however, courts began using common law doctrines to look beyond the terms of the parties' agreements in some commercial lending transactions. One tool developed by the courts is to sometimes impose duties of good faith and fair dealing between the parties, even where such duties were not expressed in the parties' agreement. After an initial rash of large lender liability judgments in the 1980's, lenders fought back and both legislative and judicial limits were eventually used to constrain various lender liability theories.

Given the economic meltdown that began in 2007, some lenders fear that courts may revert to 1980's-style views of lender liability. This issue of Dispatches from the Trenches reminds readers of the covenant of good faith included by the Uniform Commercial Code (the "UCC") and analyzes one recent case that may signal courts' renewed receptiveness to more aggressive lender liability claims in reaction to recent economic troubles.

Typical Sources of the Good Faith Obligations—The Uniform Commercial Code and The Restatement (Second of Contracts)

A duty of good faith and fair dealing may arise out of the parties' contract, or a court could impose such a duty as a matter of tort law. A contractual obligation to act in good faith may be express or implied. If the parties' written agreement contains a covenant of good faith and fair dealing, the duty is express. If the written agreement is silent on this point, however, such a duty may be implied in some circumstances.

The UCC implies a contractual duty providing: "[e]very contract or duty within this Act imposes an obligation of good faith in its performance or enforcement."[1] As such, true leases governed by Article 2A of the UCC and secured financings governed by Article 9 are subject to the implied covenant of good faith.

The UCC historically viewed the "good faith" standard applicable to lenders, as opposed to merchants, as being a purely subjective standard (sometimes colorfully referred to as the "pure heart and empty head" standard). In other words, it would be fine for a lender to act in good faith but in an unreasonable manner. More recent amendments have expanded the UCC concept to include an objective element, defining "good faith" as "honesty in fact *and the observance of reasonable commercial standards of fair dealing*."[2] That being said, as many practitioners know too well, the *Uniform* Commercial Code is not always so *uniform* and some states retain the more subjective standard in certain instances.[3]

Even in transactions, or elements of transactions, that are not governed by the UCC, courts sometimes find an implied duty of good faith and fair dealing in the parties' contract as a matter of common law. This common law concept is reflected in The Restatement (Second) of Contracts which states that "[e]very contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement." Unlike the earlier, subjective UCC approach that may still apply in some states, the Restatement speaks in terms of "good faith and fair dealing" not just "good faith." In the accompanying comments, good faith is described as "faithfulness to an agreed common purpose and consistency with the justified expectations of the other party" and as requiring "more than honesty."

Duties arising from Tort—What's the big deal?

Many lenders and lessors are familiar with the implied UCC and common law obligations to proceed in good faith—even with the idea that it may apply on an objective basis. However, a claim based in tort (rather than contract) raises significant additional issues.

One such issue relates to the type of damages that are recoverable for a breach of the covenant or duty. If the duty arises out of contract law, damages are typically limited to those damages necessary to give the non-breaching party the benefit of the bargain. These damages are referred to under the law as "compensatory damages." If the duty arises from tort law, the aggrieved party sometimes may receive, in addition to compensatory damages, other damages intended to punish the party committing the tort. These damages are referred to under the law as "punitive damages."

Courts generally find a duty to act in good faith arising as a matter of tort law only in special circumstances—such as with an employment relationship, where there is a special relationship characterized by trust and reliance. Typically such a special relationship does not exist in a commercial lending context.

Another issue arises as to whether the obligation to act in good faith (or pursuant to a reasonable objective standard) gives rise to a separate claim by an aggravated lessee or borrower. The UCC makes clear that the implied obligation of good faith does not, stating:

[The good faith obligation] does not support an independent cause of action for failure to perform or enforce in good faith. Rather, [it] means that a failure to perform or enforce, in good faith, a specific duty or obligation under the contract, constitutes a breach of that contract or makes unavailable, under the particular circumstances, a remedial right or power. This distinction makes it clear that the doctrine of good faith *merely directs a court towards interpreting contracts within the commercial context in which they are created, performed, and enforced, and does not create a separate duty of fairness and reasonableness which can be independently breached.*

Unfortunately, one recent case evidences a court's willingness to impose a separate duty of care on a lender as a matter of tort law, allowing a borrower to prosecute claims of negligence.

Court Allows Negligence Claim to Proceed Against Construction Lender

In *Jolley v. Chase Home Finance, LLC*,[4] the California Court of Appeal found that public policy may impose an additional duty of care upon a lender. The plaintiff in that case, Scott Jolley ("Borrower") entered into a construction loan agreement with Washington Mutual Bank (the "Original Lender"), to finance the renovation of rental property. Borrower alleged that the Original Lender failed to advance funds properly under the financing documents and, after Borrower's engagement of legal counsel, the loan was modified.

Before construction was complete, the Original Lender went into receivership with the FDIC, and Chase Home Finance (the "Assignee Lender") acquired the Original Lender's assets, including the financing with Borrower. According to Borrower, the Assignee Lender continued to refuse to disburse portions of the construction loan that were due, and Borrower stopped making regularly scheduled payments.

Borrower sought a subsequent loan modification from the Assignee Lender and testified that a representative of the Assignee Lender told him on many occasions in various ways that, in light of the history of problems with the Original Lender, it was “highly probable” and “likely” that the Assignee Lender “would be able to modify the loan” once construction was complete. The same representative allegedly stated that he would ask the foreclosure department to forbear from foreclosing.

Borrower evidently borrowed heavily from other funding sources to finish construction and, after months of negotiations, the Assignee Lender refused to modify the loan, demanded payment of in full and initiated foreclosure proceedings.

Borrower alleged that the delays caused by the Assignee Lender during construction prevented him from selling the property before the housing market collapsed. Two days before the scheduled foreclosure sale, Borrower sued, alleging eight causes of action. The trial court granted summary judgment in favor of the Assignee Lender, finding among other things that the Assignee Lender did not promise to modify the loan and had no obligation to do so. Borrower appealed, and the Court of Appeals reversed, allowing six causes of action to proceed to the jury, including misrepresentation, promissory estoppel, and negligence based on the Assignee Lender's own conduct.

The survival of the negligence claim is particularly significant since it reflects an additional duty from the Assignee Lender that was not otherwise reflected in the financing documents. This duty conflicts with the general idea that borrowers and lenders operate at arm's length and that a lender owes no duty of care to a borrower when the lender's involvement in the loan transaction does not exceed the scope of its conventional role as a mere lender of money. According to the Court, California courts will impose a duty of care as a matter of public policy under certain circumstances. Without deciding that such a duty existed in this case, the Court of Appeals found that there were triable issues of fact, precluding judgment as a matter of law.

The Court ruled that the trial court should have applied the following six-factor, factually oriented analysis, in order to determine whether public policy dictated imposing a duty of care on the lender in this case: (1) the extent to which the transaction was intended to affect Borrower, (2) the foreseeability of harm, (3) the degree of certainty that Borrower would suffer injury, (4) the closeness of the connection between the lender's conduct and the injury suffered, (5) the moral blame attached to the lender's conduct, and (6) the policy of preventing future harm.

The Court relied most significantly on allegations that the Assignee Lender made specific misstatements which prolonged the loan renegotiation period and encouraged Borrower to complete construction--thereby increasing the value of the collateral--while simultaneously pursuing foreclosure. The Court concluded that such allegations, if proven to be true, could be construed as morally blameworthy behavior on the part of the Assignee Lender. In light of the ongoing disputes about whether advances had been properly disbursed, the Court found the Assignee Lender should have investigated the history of the loan and taken that into account in negotiating toward a loan modification. In analyzing the policy of preventing future harm, the court also noted that, in light of the epidemic of foreclosures in recent years, there is a “rising trend” to require lenders to deal reasonably with borrowers in default to try to effectuate workable loan modifications.

Accordingly, the Court of Appeals concluded that Borrower may be able to prove facts leading to the conclusion that the bank had a duty of care to review his loan modification request and to negotiate in good faith.

Lesson

The *Jolley* decision seems to have been strongly influenced by the tanking real estate market and the epidemic of foreclosures in recent years. It remains to be seen whether an increased focus on lender liability in real estate construction and mortgage loans will lead to a similar focus in cases involving Article 9 lenders with security interests in personal property.

In any event, all lenders and lessors should be mindful of the implied covenant of good faith already present in any transaction governed by the UCC. In addition, it is crucial to set expectations carefully when discussing entrance into new transactions or loan modifications.

[1] UCC § 1-304 (previously 1-203).

[2] *See e.g.* UCC §1-201(19) (with amendments proposed by NCCUSL in 2001); UCC §9-102(a)(43) (applicable to secured financings).

[3] See e.g. Ala. Code §7-1-201(b)(20); Ala Code §7-9A-102(a)(43); A.R.S. § 47-1201B(20); O.C.G.A. § 11-1-201(19); HRS § 490:1-201; Idaho Code § 28-1-201 (b)(20). *But See* UCC §9-102(a)(43) in many of those states, which includes the objective "good faith" standard for Article 9 transactions.

[4] 213 Cal. App. 4th 872 (Cal. App. 1st Dist., February 2013)