CHAPTER 1

Structuring the Lending Relationship: Documentation Issues

Chapter Contents

§ 1.01 General Introduction

Multimillion dollar verdicts against financial institutions have become almost commonplace. Since the historic $18 million verdict in *State National Bank of El Paso v. Farah Manufacturing Co., Inc.*,[1] lender liability cases have been filed in most jurisdictions, with many resulting in large awards. Thus, five of the ten largest judgments nationally entered in 1987 were against lenders.[2] Indeed, in a four month period in 1987, the financial and legal press reported verdicts and judgments against lenders of $15,[3] $50,[4] $60,[5] $60.1,[6] $105,[7] and $129.9[8] million in state and federal courts in Maine, California, Texas, Florida and New York. While two of these judgments and sev-

[1] State National Bank of El Paso v. Farah Manufacturing Co., Inc., 678 S.W.2d 661 (Tex. App. 1984).

[2] Inside Litigation 9-10 (May 1988).

[3] "Cutoff of Credit Costly to Maine Bank," *The National Law Journal*, at p. 3 (May 4, 1987). Ricci v. Key Bancshares of Maine, Inc., 662 F. Supp. 1132 (D. Me. 1987).

[4] "BankAmerica Unit Told to Pay Damages to Family," Wall Street Journal, at p. 6 (June 23, 1987). Stangehillinis v. Bank of America, No. 35448 (Cal. Sup. Sutter County 1987).

[5] "Wells Fargo Says Farmer Was Awarded $60 Million," Wall Street Journal, at p. 13 (June 11, 1987) (Conlan v. Wells Fargo & Co. (Cal. Sup. Monterrey County 1987)).

[6] "Texas Commerce Unit Ordered to Pay Award Of $60.1 Million in Suit," Wall Street Journal, at p. 34 (June 8, 1987) (Robinson v. McAllen State Bank, No. C-1948-84-D (Tex. Dist. 1987)).

[7] "Lost Loan Results in $105M Award," *The National Law Journal*, at p. 11 (May 18, 1987) (Scharenberg v. Continental Illinois National Bank, No. 87-0238-CIV-DAVIS (S.D. Fla. Jul. 1, 1987) (Consolidated)).

[8] "Dominion Federal Plans to Post Bond of $50 Million Appeal of Loan Case," Wall Street Journal, at p. 6 (Aug. 3, 1987) (Penthouse International, Ltd. v. Dominion Federal Savings & Loan Association, 665 F. Supp. 301 (S.D.N.Y. 1987), *rev'd* 855 F.2d 963 (2d Cir. 1988)).

eral other notable ones were reversed,[9] lender liability cases continues to be filed and prosecuted on many theories.

Awards in lender liability suits have been obtained on a wide range of new and old theories. Breach of contract, fraud, misrepresentation, duress, and control are each settled common law doctrines, which are now being applied to lender liability cases, while bad faith, breach of fiduciary duty, and joint venture are new or evolving common law doctrines of lender liability. Statutory requirements, including those set forth in RICO, CERCLA, federal tax, and federal securities laws, supply additional theories of lender liability.

This book considers the lender liability field in four separate parts. The first part, composed of chapters 1 and 2, reviews lender liability pitfalls from a transactional viewpoint, starting with the initial negotiation and documentation of a loan and proceeding through the administration and workout of troubled credits. These chapters advance and analyze specific documentation and administrative techniques to minimize the risks of lender liability.

Chapters 3 through 7 review in detail new, emerging, and traditional substantive theories of lender liability, both common law and statutory. The specific theories analyzed include fraud, breach of fiduciary duty, negligent misrepresentation, RICO, duress, bad faith, the instrumentality doctrine, equitable subordination, the federal securities and tax laws, CERCLA and other environmental statutes, and aiding and abetting liability. Specific strategies to avoid liability are advanced in the particularized context of each of the distinct theories of liability.

The third part, composed of Chapters 8, 9 and 10, affords a more generalized view of lender liability from the separate viewpoints of litigation counsel, inside counsel, and the lender's own management, training and financial staff. From the perspective of litigation counsel, recurring legal issues which cut across the various theories of lender liability, including discovery, privilege and class action questions, are reviewed, with suggestions advanced for how to handle them most effectively. A separate discussion analyzes, from a litiga-

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[9] *Second Circuit:* Penthouse International, Ltd. v. Dominion Federal Savings & Loan Association, 855 F.2d 963 (2d Cir. 1988).

State Law:

California: Stanghellini Ranches, Inc. v. Bank of America National Trust & Savings Association, 3 Civ. C003244 (Cal. App. Nov. 7, 1989); Kruse v. Bank of America, 202 Cal. App. 3d 38, 248 Cal. Rptr. 217 (1988), *cert. denied sub nom.* Duck v. Bank of America, 109 S. Ct. 869 (1989).

tion perspective, how best to try a lender liability case, beginning with the development of a theme and progressing through the various stages of trial from jury selection and opening statements to the closing arguments. From the perspective of inside counsel, a framework for litigation planning and monitoring is outlined and a suggested litigation budgeting approach is advanced. Various approaches toward alternative dispute resolution are also examined. Finally, from the perspective of the lender's management, a program for designing and implementing effective training mechanisms and general policies for minimizing lender liability and related risk exposures is set forth.

The final part of this book, composed of Chapters 11, 12 and 13, analyzes additional areas of litigation that affect financial institutions. Chapter 11 discusses the duties of directors and officers of financial institutions, and evaluates various theories of liability under both the common law and relevant statutes. Chapter 12 reviews lender liability in the context of failed financial institutions, including the application of the *D'Oench, Duhme* doctrine, 12 U.S.C. § 1823 (e), and the federal holder in due course doctrine. Chapter 13 deals with claims made by financial institutions arising out of loan participations.

§ 1.02 Processing of Loan Applications

Ordinarily, the mere submission of a loan application does not create a duty on the part of the prospective lender to act on the application promptly or with due care.[1] Nor generally does a lender owe a duty to process a borrower's request for a loan modification.[1.1] However, a gradual erosion of this doctrine has begun to evolve, particularly in the area of residential mortgage lending. Several courts have enunciated some limited circumstances under which lenders may have a contractual obligation or tort duty to process a mortgage or consumer loan application. These decisions fall generally into four broad categories, involving respectively cases (1) imposing a broad duty of due care in processing a loan application,[2] (2) imposing such a duty where

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[1] Fourth Circuit: Silver Hill Station Limited Partnership v. HSA/Wexford Bancgroup, LLC, 158 F. Supp.2d 631 (D. Md. 2001) (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).

Eighth Circuit: Nelson v. Production Credit Association, 930 F.2d 599, 605-606 (8th Cir. 1991) (applying Nebraska law).

Ninth Circuit: Spencer v. DHI Mortgage Co., 642 F. Supp.2d. 1153 (E.D. Cal. 2009) (a lender owes no duty of care to borrowers in approving a loan; liability to a borrower for negligence arises only when the lender "actively participates" in the financed enterprise "beyond the domain of the usual money lender"; thus, as a general rule, a financial institution owes no duty of care to a borrower to determine the borrower's ability to repay a loan; the lender's efforts to determine the creditworthiness and ability to repay by a borrower are for the lender's protection, not the borrower's).

State Courts:

Alabama: Flying J Fish Farm v. Peoples Bank of Greensboro, 12 So.3d 1185 (Ala. 2008) (as matter of first impression, bank cannot be held liable to customer for negligence or wantonness on theory that bank loaned customers money for use in their business when both bank and customers appreciated that there was substantial risk that revenues from business would not be sufficient to repay loan).

California: Wagner v. Benson, 101 Cal. App. 3d 27, 161 Cal. Rptr. 516 (1980).

Maryland: Jacques v. First National Bank, 307 Md. 527, 515 A.2d 756 (1986).

[1.1] See, e.g., Zierolf v. Wachovia Mortgage, 2012 WL 6161352 (N.D. Cal. Dec. 11, 2012) (applying California law) (no justifiable reliance on defendant/lender's representations to process modification as HAMP confers no rights or duties). But *cf.*, Becker v. Wells Fargo Bank, NA, Inc., 2012 WL 6005759 (E.D. Cal. Nov. 30, 2012) (applying California law) (fraud claim survived MTD as alleged material representations resulted in reliance and damages).

[2] District of Columbia Circuit: High v. McLean Financial Corp., 659 F. Supp. 1561 (D.D.C. 1987).

State Courts:

Alabama: First Federal Savings & Loan Ass'n. v. Caudle, 425 So.2d 1050 (Ala. 1982).

Maryland: Jacques v. First National Bank, 307 Md. 527, 515 A.2d 756 (1986).

Ohio: Toledo OJ, Inc. v. Fifth Third Bank, 2001 WL 969134 (Ohio App. Aug. 24, 2001) (bank breached "initial loan processing agreement" when it took more than one and a half months to issue a commitment letter after bank's employee had told borrower that it would take five days to process loan after loan application and documentation had been submitted by borrower).

the lender is an active participant in a home construction or business enterprise,[3] (3) requiring disclosures regarding insurance options,[4] and (4) prohibiting evasion of truth-in-lending requirements.[5]

The cases imposing the broadest duty on prospective lenders have held that a voluntary agreement to assist a home purchaser arises by accepting and processing a loan application, and requires that the lender act promptly and with due care.[6] Thus, telling prospective home buyers that there were "no problems" with their application,[7] or that they had been approved for an FHA loan, when they had not,[8] or failing to exercise the degree of care in evaluating a potential home buyer's financial qualifications that a reasonably prudent lender would have exercised under the same or similar circumstances,[9] each

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South Dakota: Brandriet v. Norwest Bank South Dakota, N.A., 499 N.W.2d 613 (1993) (false representations made that bank was certified to process VA loan applications).

[3] *California:* Wagner v. Benson, 101 Cal. App.3d 27, 161 Cal. Rptr. 516 (1980); Connor v. Great Western Savings & Loan Ass'n., 69 Cal.2d 850, 73 Cal. Rptr. 369, 447 P.2d 609 (1968).

[4] *Connecticut:* Small v. South Norwalk Savings Bank, 205 Conn. 751, 535 A.2d 1292 (1988).

Ohio: Walters v. First National Bank, 69 Ohio St. 2d 677, 433 N.E.2d 608 (1982); Stone v. Davis, 66 Ohio St.2d 74, 419 N.E.2d 1094 (1981), *cert. denied sub nom.* Cardinal Federal Savings & Loan Ass'n. v. Davis, 454 U.S. 1081 (1981).

Washington: Hutson v. Wenatchee Federal Savings & Loan Ass'n., 22 Wash. App. 91, 588 P.2d 1192 (1978).

[5] Faison v. Nationwide Mortgage Corp., 832 F.2d 616 (D.C. Cir. 1987), *cert. denied sub nom.* Boddie v. Faison, 109 S.Ct. 70 (1988).

For a discussion of claims under the federal Truth in Lending Act, see § 14.04 *infra*.

[6] See cases cited at N. 2 *supra*.

[7] High v. McLean Financial Corp., 659 F.Supp. 1561 (D.D.C. 1987).

[8] First Federal Savings & Loan Ass'n. v. Caudle, 425 So.2d 1050 (Ala. 1982).

[9] Jacques v. First National Bank, 307 Md. 527, 515 A.2d 756, 764-765 n.7 (Md. App. 1986) (lender allegedly departed from industry standards in four respects: "1) The loan officer averaged only two years of the Jacques' income. Bank practice usually involved an evaluation of the applicant's tax returns for the preceding three years. In addition, the officers knew that due to illness the Jacques' income for the two years was lower than usual and, therefore, distorted their financial status; 2) Payments on the Jacques' current home were erroneously included in the calculation. The Bank typically reviewed only unsecured consumer debts, as provided by the guidelines; 3) Income from stock was not considered at all. Its inclusion would have bolstered the strength of the Jacques' income; 4) The loan officer placed excessive weight on the factor of debt-to-income ratio and failed to properly balance that factor against a very favorable credit history and a substantial net worth.").

But *cf.*, Frappier v. Countrywide Home Loans, Inc., 645 F.3d 51 (1st Cir. 2011) (applying Massachusetts law) (negligence claim could not be stated against lender based solely on borrower's allegation that lender was careless in extending loan that borrower was unlikely to repay; rather, borrower was required to demonstrate that he had fiduciary relationship with lender; in the case at bar, fact that borrower worked with lender's loan originator for months, had his personal telephone number, and trusted him because loan originator repeatedly offered to "take care" of his mortgage,

has been held to state a tort cause of action in negligence, potentially giving rise to a punitive damages award.[10] Several factual limitations restrict the scope of this duty, as the cases imposing such a duty emphasize that the lenders expressly undertook to process the applications, often charging a fee for doing so, and communicated with the prospective borrowers about the status of their applications. In addition, the leading case involved substantial reliance damages known to the lender, where the borrowers had been induced to do business with it by promises of a guaranteed rate of interest lower than that otherwise available, and the borrowers were obligated by their residential sales contract to increase their down payment to whatever amount was required to qualify for a mortgage loan.[11] Finally, cases applying Colorado law have held that any duty to process a loan application is enforceable only in a contract action, and that no tort claim for negligence is recognized under Colorado law.[12]

A second category in which a duty of care may arise in processing a loan application is that in which the lender has gone beyond a traditional lending relationship.[13] In such cases, the lender may be held liable for negligently making a loan to borrowers it should have known were too inexperienced to realize the risky nature of the investment in which the lender was an active participant.[14]

Lenders have also been held to a fiduciary duty of disclosure in processing a loan application from young and inexperienced home purchasers, where the subject of life insurance was raised.[15] These cases require a lender to disclose and explain the availability of mortgage life insurance to such borrowers on the theory that "[t]he facts surrounding and the setting in which a bank gives advice to a loan customer on the subject of mortgage insurance warrant a conclusion that, in this aspect of the mortgage loan process, the bank acts as its customer's fiduciary and is under a duty to fairly disclose to the customer the mechanics of

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were mundane, and were not so extreme as to establish special trust and reliance needed for fiduciary relationship).

[10] Id., 515 A.2d at 765.

[11] Id., 515 A.2d at 764.

[12] *Tenth Circuit:* Gilmore v. Ute City Mortgage Co., 660 F. Supp. 437 (D. Col. 1986).

State Courts:

Colorado: Centennial Square, Ltd. v. Resolution Trust Co., 815 P.2d 1002 (Col. 1991).

[13] Avila v. Wells Fargo Bank, 2012 WL 2953117 (N.D. Cal. July 19, 2012) (applying California law) (duty of care arose when attendant to a loan modification, defendant/mortgagee "discussed" and presented "actual figures" but rejected those monies tendered by plaintiff/mortgagor).

[14] Wagner v. Benson, 101 Cal. App.3d 27, 161 Cal. Rptr. 516 (1980).

[15] See cases cited in N. 4 *supra*.

procuring such insurance."[16] A Connecticut case has also held that it can be actionable negligence for a lender to fail to advise a borrower to obtain flood insurance on a mortgaged property.[17] Other cases have rejected such a theory[18] or reserved the question.[19]

Lenders have also been found potentially to owe a duty of care to prospective borrowers in processing a loan application where they counsel a consumer borrower to execute documents which nullify applicable truth-in-lending protections, and the borrower later sustains a loss as a result of such a waiver.[20] Some courts have also held that a confidential relationship exists between a lender and its customer in the processing of Small Business Administration or Veterans Administration loans.[21]

While these cases represent only an emerging trend in some states, and do not yet constitute a settled line of precedent, they caution the need for great care by lenders in processing any loan application in a context in which the prospective borrower is financially unsophisticated. It is especially important to exercise great care where the lender undertakes to work with such a borrower on a transaction in which a significant degree of risk to the prospective borrower is disclosed either orally, in the documentation submitted to the lender or by the very nature of the transaction being financed. In any event, lenders should act promptly in processing any loan application and should avoid oral communications that encourage prospective borrowers to conclude that their applications will be approved. Training of bank employees in this area should include administrative and secretarial personnel as well as lenders since mortgage and consumer borrowers will often call the lender's office to verify the status of their loan application.[22]

Finally, when processing loan applications a lender must be careful not to engage in the unauthorized practice of law, for which it may be held liable under state law. Thus, for example, the court in *Eisel*

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[16] Stone v. Davis, 66 Ohio St.2d 74, 78, 79, 419 N.E.2d 1094, 1097, 1098 (1981), *cert. denied sub nom.* Cardinal Federal Savings & Loan Ass'n v. Davis, 454 U.S. 1081 (1981) (holding that when lender "negligently failed to adhere to its customary policy of informing [borrowers] . . . that they must procure the mortgage insurance themselves, it breached the fiduciary duty of fair disclosure which it owed to them").

[17] Small v. South Norwalk Savings Bank, 205 Conn. 751, 535 A.2d 1292 (1988).

[18] Lehmann v. Arnold, 137 Ill. App. 3d 412, 484 N.E.2d 473 (1985).

[19] Hofbauer v. Northwestern National Bank, 700 F.2d 1197, 1201 (8th Cir. 1983).

[20] Faison v. Nationwide Mortgage Corp., 832 F.2d 616 (D.C. Cir. 1987), *cert. denied sub nom.* Boddie v. Faison, 109 S.Ct. 70 (1988).

[21] Buxcel v. First Fidelity Bank, 601 N.W. 2d 593 (S.D. 1999) (SBA Loan); Brandriet v. Norwest Bank, 499 N.W.2d 613 (S.D. 1993) (VA Loan).

[22] First Federal Savings & Loan Ass'n. v. Caudle, 425 So.2d 1050 (Ala. 1982).

v. Midwest BankCentre[23] held that a bank's conduct in charging customers a document preparation fee in connection with real estate financing transactions clearly violated a statutory ban[24] on the unauhorized practice of law. The plaintiffs were accordingly awarded treble damages[25] as well as other damages and costs.

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[23] Eisel v. Midwest BankCentre, 230 S.W.3d 335 (Mo. 2007).

[24] Mo. Rev. Stat. §§ 484.010.2, 484.020.1. The forms involved in the case included: a deed of trust and a promissory note, as well as various other documents, depending on the loan involved. The court indicated that there was no question but that the preparation of the deed of trust and the promissory note constituted the practice of law. It was not necessary to the court's decision to consider any of the other documents.

[25] These damages were authorized by Mo. Rev. Stat. § 484.020.2.

§ 1.03 Commitments

[1]—Oral Promises to Lend

[a]—The Conflicting Case Law

Promises by a bank officer to make a loan to a prospective borrower may, without more, bind a lender to make such a loan on a contract,[1] promissory estoppel,[2] or fraud[3] theory. Such promises have

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[1] *Fourth Circuit:* Coastland Corp. v. Third National Mortgage Co., 611 F.2d 969 (4th Cir. 1979) ($620,650 award upheld) (applying Virginia law).

Ninth Circuit: Landes Construction Co. v. Royal Bank, 833 F.2d 1365 (9th Cir. 1987) ($18.5 million jury verdict upheld) (applying California law).

Tenth Circuit: National Farmers Organization, Inc. v. Kinsley Bank, 731 F.2d 1464 (10th Cir. 1984) (applying Kansas law); In Re Werth, 37 Bankr. 979, 989-990 (Bankr. D. Col. 1984), *aff'd* 54 Bankr. 619 (D. Col. 1985) (applying Colorado law).

State Courts:

Arizona: K-Line Builders, Inc. v. First Federal Savings & Loan Ass'n, 139 Ariz. 209, 677 P.2d 1317 (Ariz. Appl. 1983).

Illinois: Wait v. First Midwest Bank/Danville, 142 Ill. App.3d 703, 96 Ill. Dec. 516, 491 N.E.2d 795 (1986).

North Dakota: Delzer v. United Bank, 459 N.W. 2d 752 (1990).

Oregon: Bixler v. First National Bank, 49 Ore. App. 195, 619 P.2d 895 (1980).

Pennsylvania: Bolus v. United Penn Bank, 363 Pa. Super. 247, 525 A.2d 1215 (1987) ($375,000 Verdict upheld).

Texas: American Bank v. Thompson, 660 S.W.2d 831 (Tex. App. 1983).

[2] *Ninth Circuit:* Errico v. Pacific Capital Bank, N.A., 2010 WL 4699394 (N.D. Cal. Nov. 9, 2010) (borrowers stated promissory estoppel claim against lenders under California law by alleging that there was clear promise to finance entire development project in minimum amount of 75% of appraised value, that they reasonably relied on promise based on lenders' role as "financial adviser" to them over period of approximately two years, that they experienced substantial detriment by investing substantial time and money in design and construction costs, and took on substantial credit obligations in two loans for improvements on assurance that lender would finance entire project, and that they suffered actual damages in design and construction costs, loan fees, and lost profits from both commercial plaza and condominiums when lenders failed to honor promise).

Tenth Circuit: Zimmerman v. First Federal Savings & Loan Ass'n, 848 F.2d 1047, 1053-1054 (10th Cir. 1988) ($1.5 million verdict upheld) (applying Wyoming law); Becker v. HSA/Wexford Bancgroup, L.L.C., 157 F. Supp.2d 1243 (D. Utah 2001) (applying Utah law) (defendant's motion for summary judgment on promissory estoppel claim denied when plaintiff presented evidence that (1) lender represented both orally and through its actions in continuing to process loan that there was valid loan commitment between parties; (2) borrowers relied on representations; and (3) borrowers suffered damages (by paying fees to lender, by paying to perform loan conditions, and by having to find another lender that charged higher interest rate, etc.); In Re Werth, 37 Bankr. 979, 990-991 (Bankr. D. Col. 1984), *aff'd* 54 Bankr. 619 (D. Col. 1985) (applying Colorado law).

State Courts:

California: A-C Company. Inc. v. Security Pacific National Bank, 173 Cal. App.3d 462, 219 Cal. Rptr. 62 (1985).

been upheld as binding on the lender even where not all of the loan terms had been negotiated,[4] and courts have rejected attempts to

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Florida: United of Omaha Life Ins. Co. v. Nob Hill Associates, 450 So.2d 536 (Fla. App. 1984).

Indiana: First National Bank v. Logan Manufacturing Co., Inc., 577 N.E.2d 949 (Ind. 1991).

Minnesota: Bandal v. Baldwin, No. C0-00-1007, 2000 Minn. App. LEXIS 1169 (Minn. App. Nov. 21, 2000) (promissory estoppel claim stated against borrower who accepted check payable to him and his company even in the absence of a written agreement between the parties).

Oregon: Bixler v. First National Bank, 49 Ore. App. 195, 619 P.2d 895 (1980).

Texas: MBank Abilene, N.A. v. LeMaire, Case No. C14-86-00834-CV (Tex. App. April 6, 1989).

But see:

Second Circuit: Woodwinds, Inc. v. Dimeo, No. 99-9473, 2000 U.S. App. LEXIS 23948 (2d Cir. Sept. 27, 2000) (promissory estoppel claim properly dismissed for lack of a clear and definite promise regarding long-term financing).

State Courts:

Massachusetts: Rhode Island Hospital Trust National Bank v. Varadian, 419 Mass. 841, 647 N.E.2d 1174 (1995) (reversing verdict based on promissory estoppel theory for breach of an oral promise to lend money; court found that no unambiguous promise to lend was made, since the parties both understood that a written agreement had to be entered into, and that any reliance by the borrowers was therefore unreasonable as a matter of law).

Minnesota: Brickwell Community Bank v. Wycliff Associates II, LLC, 2011 WL 1237524 (Minn. App. April 5, 2011) (unpublished) ("to allow promissory estoppel to remove an oral promise to extend credit from the application of [the statute of frauds] would nullify the statute").

[3] Riverside National Bank v. Lewis, 603 S.W.2d 169 (Tex. 1980). See also 1001 McKinney Ltd. v. Credit Suisse First Boston Mortgage Capital, 2005 WL 3116463 (Tex. App. 2005) (although claim for breach of oral loan agreement was barred by statute of frauds, plaintiff could recover damages on fraud claim with proof of actual and justifiable reliance on alleged promises to fund loan).

[4] *Fourth Circuit:* Coastland Corp. v. Third National Mortgage Co., 611 F.2d 969, 995-996 (4th Cir. 1979) (applying Virginia law).

Ninth Circuit: Landes Construction Co., Inc. v. Royal Bank, 833 F.2d 1365 (9th Cir. 1987) (applying California law).

Tenth Circuit: National Farmers Organization, Inc. v. Kinsley Bank, 731 F.2d 1464 (10th Cir. 1984) (applying Kansas law).

Eleventh Circuit: Softball Country Club-Atlanta v. Decatur Federal Savings & Loan Ass'n, 121 F.3d 649, 652-653 (11th Cir. 1997) (applying Georgia law).

State Courts:

Texas: MBank Abilene, N.A. v. LeMaire, Case No C14-86-00834-CV (Tex. App. April 6, 1989).

Cf.:

Idaho: Lettunich v. Key Bank National Assoc., 141 Idaho 362, 109 P.3d 1104 (Idaho 2005) (a lender may be bound by the terms of an oral agreement pursuant to the doctrine of part performance, but only if the oral agreement is "complete, definite and certain in all its material terms" or contains provisions that are capable in themselves of being reduced to certainty; in this case, there was no evidence in the record of the amount of the loan, the interest rate, the disbursement schedule, the terms of repayment, the security for the loan, or the parties' rights after default; while

avoid the binding effect of such oral promises based on arguments that the loan officer lacked the power to bind the bank;[5] that the loan officer violated his individual lending limit by making the promise;[6] that the bank's lending limits were exceeded by the promise;[7] and that the statute of frauds would be violated by enforcing the promise.[8]

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none of these terms individually might be determinative, the lack of all of them made the oral agreement to lend money vague, incomplete and unenforceable).

Mississippi: Patton v. State Bank & Trust Co., 2006 WL 771660 (Miss. App. 2006) (plaintiff alleged that lender made oral commitment to finance purchase price of building and also to lend sufficient funds to convert building into blues club and restaurant, but plaintiff could not state how much money bank promised it would lend him to aid with renovations, could not state agreed upon interest rate or what type of payment plan would be utilized, and there was no evidence as to whether parties ever agreed on what type of collateral would be used to secure loan; alleged oral contract was thus indefinite and vague, at best; court could have no way of ascertaining terms of contract even if it were inclined to find contract had been formed).

[5] Bolus v. United Penn Bank, 363 Pa. Super. 247, 525 A.2d 1215 (1987).

[6] *Id.*

[7] *Tenth Circuit:* National Farmers Organization, Inc. v. Kinsley Bank, 731 F.2d 1464 (10th Cir. 1984) (applying Kansas law).

State Courts:

Texas: MBank Abilene, N.A. v. LeMaire, Case No. C14-86-00834-CV (Tex. App. April 6, 1989).

[8] *Ninth Circuit:* Landes Construction Co., Inc. v. Royal Bank, 833 F.2d 1365 (9th Cir. 1987) (applying California law).

Tenth Circuit: Zimmerman v. First Federal Savings & Loan Ass'n, 848 F.2d 1047, 1054-1055 (10th Cir. 1988) (applying Wyoming law); In re Werth, 37 Bankr. 979, 989 (Bankr. D. Col. 1984), *aff'd* 54 Bankr. 619 (D. Col. 1985) (applying Colorado law).

Eleventh Circuit: Softball Country Club-Atlanta v. Decatur Federal Savings & Loan Ass'n, 121 F.3d 649, 652-653 (11th Cir. 1997) (applying Georgia law).

State Courts:

Alabama: First Federal Savings & Loan Ass'n v. Caudle, 425 So.2d 1050 (Ala. 1982).

North Dakota: Delzer v. United Bank, 459 N.W.2d 752 (1990).

Texas: American Bank v. Thompson, 660 S.W.2d 831 (Tex. App. 1983).

But cf.:

Alabama: Southland Bank v. A & A Drywall Supply Co., 2008 WL 5195187 (Ala. Dec. 12, 2008) (allegation that senior vice president promised prospective borrowers to extend $500,000 loan if Small Business Administration (SBA) issued guarantee for loan could not be basis of claim for negligent failure to provide loan; violation of duty to assume or extend loan was essentially breach of contractual duty to perform under loan agreement, and, because the purported contract was not in writing, it violated the statute of frauds).

Kentucky: Farmers Bank and Trust Co. of Georgetown, Ky. v. Willmott Hardwoods, Inc., 171 S.W.3d 4 (Ky. 2005) (when the statute of frauds is clear and unambiguous, equitable relief should be granted only under the most limited of circumstances, so that the court does not, in effect, judicially amend the statute in violation of separation of powers; in this case, debtor was not ready, willing, and able to close loan on agreed closing date, and by express terms of contract, agreement for the loan expired; although bank continued to discuss possibility of making the loan to debtor thereafter, it was under no obligation to do so and was not estopped from enforcing express terms of Commitment Letter by refusing to grant loan).

Courts are particularly likely to uphold such an oral promise to lend when the lender has partially performed the promise, such as by advancing some funds.[9] Where these types of promises have been enforced, some borrowers have been able to recover lost profits[10] and

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North Dakota: Smestad v. Harris, 796 N.W.2d 662 (N.D. 2011) ("Because an oral agreement is neither in writing nor subscribed by the party to be charged . . . the statute of frauds defense . . . applies to an oral promise to make a loan. . . . If the aggregate amount of a series of loans is $25,000 or more, an oral agreement for the loans is unenforceable.").

Ohio: Stonecreek Properties Ltd. v. Ravenna Savings Bank, 2004 WL 1559725 (Ohio App. 2004) (under Ohio law [Ohio Rev. Code Ann. § 1335.02(B)], the statute of frauds requires loan agreements to be in writing and signed by the party against whom an action will be brought or by the authorized representative of the party, unless the loan agreement is in the form of a promissory note or other document or commitment that describes the credit or loan, and the loan agreement, by its terms, satisfies all of the following conditions: (1) the loan agreement is intended by the parties to be signed by the debtor but not by an officer or other authorized representative of the financial institution; (2) the loan agreement has been signed by the debtor; and (3) the delivery of the loan agreement has been accepted by the financial institution).

See also § 1.03[1][b] *infra*.

A Lender's Motion for Summary Judgment raising the statute of frauds is reproduced in Appendix M *infra,* together with the supporting Memorandum of Law and Statement of Undisputed Facts. The lender was awarded summary judgment in this matter on this point after the case was remanded to state court. Guisewhite v. Muncy Bank & Trust Co., No. 95-01173 (Comm. Pleas Pa. Dec. 4, 1996).

[9] *Ninth Circuit:* Landes Construction Co., Inc. v. Royal Bank, 833 F.2d 1365 (9th Cir. 1987) (applying California law).

Tenth Circuit: In re Werth, 37 Bankr. 979, 989 (Bankr. D. Col. 1984), *aff'd* 54 Bankr. 619 (D. Col. 1985) (applying Colorado law); National Farmers Organization, Inc. v. Kinsley Bank, 731 F.2d 1464 (10th Cir. 1984) (applying Kansas law).

See also:

State Courts:

Idaho: Lettunich v. Key Bank National Assoc., 141 Idaho 362, 109 P.3d 1104 (Idaho 2005) (to be specifically enforced by operation of the doctrine of part performance, an oral agreement "must be complete, definite and certain in all its material terms, or contain provisions which are capable in themselves of being reduced to certainty"; in this case, there was no evidence in the record of the amount of the loan, the interest rate, the disbursement schedule, the terms of repayment, the security for the loan, or the parties' rights after default; while none of these terms individually were determinative, the lack of all of them made the oral agreement to lend money vague, incomplete and unenforceable).

[10] *Tenth Circuit:* Zimmerman v. First Federal Savings & Loan Ass'n, 848 F.2d 1047 (10th Cir. 1988) (applying Wyoming law) (alternative ground).

State Courts:

Iowa: Harsha v. State Savings Bank, 346 N.W.2d 791 (Iowa 1984) ($126,000 award upheld).

Maryland: Sergeant Company v. Clifton Building Corp., 47 Md. App. 307, 423 A.2d 257 (1980).

Pennsylvania: Bolus v. United Penn Bank, 363 Pa. Super. 247, 525 A.2d 1215 (1987).

incidental damages,[11] although two leading cases enforcing promises to lend nevertheless vacated lost profits awards.[12]

One of the largest awards upheld to date on appeal for breach of an oral promise to lend was the $18.5 million jury verdict in *Landes Construction Co. v. Royal Bank*.[13] There the jury found that a lender had agreed to lend the plaintiff corporation $10 million to finance the purchase of commercial real estate, based upon the oral promise of a bank vice president. In upholding the verdict, the Ninth Circuit stressed that the essential terms of the financing had been agreed upon, that $3 million had been advanced to the plaintiff against a co-venturer's established credit line, and that a similar project involving the same two co-venturers had previously been financed by the bank in the same fashion, with the debt transferred to the project when the paperwork for it was completed.[13.1]

Other courts that have reviewed alleged oral agreements to lend have taken a stricter and more technical approach to the issue of whether an agreement has been proved, refusing to enforce such promises where all the essential terms of the financing, including amount, duration of loan, rate of interest, working capital and debt-to-equity ratios, and terms of repayment, have not been worked out between the parties.[14]

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[11] *Tenth Circuit:* National Farmers Organization, Inc. v. Kinsley Bank, 731 F.2d 1464 (10th Cir. 1984) (applying Kansas law).

State Courts:

Oregon: Bixler v. First National Bank, 49 Ore. App. 195, 619 P.2d 895 (1980).

Vermont: Stacy v. Merchants Bank, 144 Vt. 515, 482 A.2d 61 (1984).

[12] *Fourth Circuit:* Coastland Corp. v. Third National Mortgage Co., 611 F.2d 969, 976-978 (4th Cir. 1979) (applying Virginia law).

Tenth Circuit: National Farmers Organization, Inc,. v. Kinsley Bank, 731 F.2d 1464 (10th Cir. 1984) (applying Kansas law).

[13] Landes Construction Co. v. Royal Bank, 833 F.2d 1365 (9th Cir. 1987) (applying California law).

[13.1] Other courts have also upheld claims of an oral contract, choosing to supply any terms missing from the contract from written documents which existed or from the parties' course of dealings.

See, e.g.:

Montana: C B & F Development Corp. v. Culbertson State Bank, 256 Mont. 1, 844 P.2d 85 (1992).

Oregon: Siegner v. Interstate Production Credit Association, 109 Or.App. 417, 820 P.2d 20 (1991).

Texas: MBank Abilene, NA. v. LeMaire, Case No. C14-86-00834-CV (Tex. App. April 6, 1989).

[14] *Second Circuit:* Philips Credit Corp. v. Regent Health Group, Inc., 953 F. Supp. 482, 513-514 (S.D.N.Y. 1997) (applying New York law); Fasolino Foods Co., Inc. v. Banca Nazionale de Lavoro, 761 F. Supp. 1010, 1019-1020 (S.D.N.Y. 1991), *aff'd* 961 F.2d 1052 (2d. Cir. 1992).

Sixth Circuit: In Red Cedar Construction Co., 63 Bankr. 228, 239 (Bankr. W.D. Mich. 1986).

In anIllinois case, for example, an oral agreement to continue a loan as long as progress was being made to restore profitability in the borrower's business was held too indefinite in duration to constitute an enforceable contract.[15] Similarly, in reversing a multimillion dollar jury verdict for bad faith denial of a contract, an intermediate California appellate court found no enforceable agreement to lend since the amount of the loan, the rate of interest, the terms of repayment, and the applicable loan fees and charges had not been resolved even though bank documents referred to an intent to make a loan.[16] These cases differ from those previously discussed principally in refusing to construct the missing terms of an agreement by referring to "commercial practice and the customary course of business between the bank and (borrower)."[17]

[b]—New Statutory Initiatives

In reaction to the proliferation of lender liability complaints by borrowers relying upon purported oral agreements, a majority of

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Eighth Circuit: Nelson v. Production Credit Association, 930 F.2d 599, 604-605 (8th Cir. 1991) (applying Nebraska law).

District of Columbia Circuit: Stansel v. American Security Bank, 547 F.2d 990 (D.C. Cir. 1988), *cert. denied* 109 S.Ct. 1746 (1989).

State Courts:

Alabama: Armstrong Business Services, Inc. v. AmSouth Bank, 2001 WL 996066 (Ala., Aug. 31, 2001) (no evidence of consideration for loan commitment).

California: Kruse v. Bank of America, 202 Cal. App. 3d 38, 248 Cal. Rptr. 217 (1988), *cert. denied sub nom*. Duck v. Bank of America, 109 S.Ct. 869 (1989).

Georgia: Moore v. Bank of Fitzgerald, 225 Ga. App. 122, 127, 483 S.E.2d 135, 140 (1997).

Illinois: The Delcon Group, Inc. v. Northern Trust Corp., 187 Ill. App. 3d 635, 543 N.E.2d 595 (1989); Champaign National Bank v. Landers Seed Co., 165 Ill. App. 3d 1090, 116 Ill. Dec. 742, 519 N.E.2d 957 (1988).

Indiana: First National Bank v. Logan Manufacturing Co., Inc., 577 N.E.2d 949 (Ind. 1991).

Missouri: Dennis Chapman Toyota, Inc. v. Belle State Bank, 759 S.W.2d 330 (Mo. App. 1988).

North Dakota: Union State Bank v. Woell, 434 N.W.2d 712 (1989).

Wyoming: Doud v. First Interstate Bank, 769 P.2d 927 (1989).

A Lender's Motion for Summary Judgment raising the uncertainty of essential terms of the alleged oral contract is reproduced in Appendix M *infra,* together with the supporting Memorandum of Law and Statement of Undisputed Facts. The lender was awarded summary judgment in this matter on this point after the case was remanded to state court. Guisewhite v. Muncy Bank & Trust Co., No. 95-01173 (Pa. Comm. Pleas Dec. 4, 1996).

[15] Champaign National Bank v. Landers Seed Co., 165 Ill. App. 3d 1090, 116 Ill. Dec. 742, 519 N.E.2d 957 (1988).

[16] Kruse v. Bank of America, 202 Cal. App.3d 38, 248 Cal. Rptr. 217 (1988), *cert. denied sub nom*. Duck v. Bank of America, 109 S.Ct. 869 (1989).

[17] *Tenth Circuit:* National Farmers Organization, Inc. v. Kinsley Bank, 731 F.2d 1464, 1470 (10th Cir. 1984).

states has now enacted special legislation requiring that certain types of agreements relating to financings be in writing to be enforceable.[17.1]

State Courts:

Illinois: Wait v. First Midwest Bank/Danville, 142 ill. App.3d 703, 96 Ill. Dec. 516, 491 N.E.2d 795 (1986).

[17.1] *Alabama:* Ala. Code § 8-9-2(7).

Alaska: Alaska Stat. § 09.25.010(a)(13).

Arizona: Ariz. Rev. Stat. Ann. § 44-101(9).

Arkansas: Ark. Stat. Ann. § 4-59-101.

California: Cal. Civ. Code § 1624(a)(7) (applies only to "a contract, promise, undertaking, or commitment to loan money or to grant or extend credit, in an amount greater than one hundred thousand dollars ($100,000), not primarily for personal, family, or household purposes, made by a person engaged in the business of lending or arranging for the lending of money or extending credit").

Colorado: Col. Rev. Stat. § 38-10-124. See, e.g.: Woods v. First National Bank of Durango, 2012 WL 4378536 (D. Col. Sept. 25, 2012) (applying Colorado law) (plain language of statute requires that "credit agreement" involving principal amount in excess of $25,000 be in writing); Premier Farm Credit, PCA v. W-Cattle, LLC, 155 P.3d 504 (Col. App. 2006) (by enacting credit agreement statute of frauds, legislature hoped to curtail suits against lenders based on oral representations made by members of credit industry).

Connecticut: Conn. Gen. Stat. Ann. § 52-550(a)(6) (any agreement for a loan in an amount that exceeds fifty thousand dollars).

Delaware: 6 Del. Code Ann. § 2714(b) (a contract, promise, undertaking or commitment to loan money or to grant or extend credit, or any modification thereof, in an amount greater than $ 100,000, not primarily for personal, family, or household purposes).

Florida: Fla. Stat. Ann. § 687.0304.

Georgia: Ga. Code Ann. § 13-5-30(7). See Moore v. Bank of Fitzgerald, 225 Ga. App. 122, 483 S.E.2d 135 (1997).

Idaho: Idaho Code § 9-505 subd. 5 (a promise or commitment to lend money or to grant or extend credit in an original principal amount of fifty thousand dollars ($ 50,000) or more, made by a person or entity engaged in the business of lending money or extending credit). See: Lettunich v. Key Bank National Ass'n., 141 Idaho 362, 109 P.3d 1104 (2005) (Section 9-505(5) barred enforcement of alleged oral agreement by bank to make loan); Rule Sales & Service, Inc. v. U.S. Bank National Ass'n., 133 Idaho 669, 991 P.2d 857 (Idaho App. 1999).

Illinois: Ill. Comp. Stat. Ann. Ch. 815, *§* 160/2. See Bank One, Springfield v. Roscetti, 309 Ill. App.3d 1048, 723 N.E.2d 755, 243 Ill. Dec. 452 (Ill. App. 1999) (reviewing cases decided under the Act).

Iowa: Iowa Code § 535.17(1).

Kansas: Kan. Stat. Ann. §§ 16-117, 16-118.

Kentucky: Ky. Rev. Stat. Ann. § 371.010(9). See also, e.g., Farmers Bank and Trust Co. of Georgetown, Ky. v. Willmott Hardwoods, Inc., 171 S.W.3d 4 (Ky. 2005) (statute requires promise, contract, agreement, undertaking, or commitment to loan money to be in writing and signed by the party to be charged; statute applies to material modifications of such agreements as well; thus, oral modification of loan commitment was ineffective to extend closing date because it failed to satisfy statute).

Louisiana: La. Rev. Stat. Ann. §§ 6:1121-6:1123. See Guzzardo-Knight v. Central Progressive Bank, 762 So.2d 1243 (La. App. 2000) ("[T]he legislature intended to bar liability suits against lenders involving assertions of a breach of oral agreements to lend money. To allow a plaintiff to recover damages based on legal theories other

than breach of contract, where the breach of the financial institution's oral promise to lend money forms the very basis of those alternate legal theories, would render the statute meaningless. Therefore, we hold plaintiffs' causes of action for fraud, negligent misrepresentation and detrimental reliance, which arise out of an oral credit agreement, are barred by La. R. S. 6:1122.").

Maryland: Md. Cts. & Jud. Proc. Code Ann. § 5-408(b).

Michigan: Mich. Comp. L § 566.132(2). See Crown Technology Park v. D&N Bank, FSB, 242 Mich. App. 538, 619 N.W.2d 66 (Mich. App. 2000) (holding that statute of frauds bars all claims involving oral promises by a financial institution, including claims based upon promissory estoppel).

Minnesota: Minn. Stat. Ann. § 513.33.

Montana: Mont. Code Ann. § 31-3-116. See, e.g., KeyBank National Ass'n. v. Voyager Group, L.P., 2012 WL 4048850 (W.D. Pa. Sept. 13, 2012) (applying Montana law), *reconsideration denied* 2012 WL 5458948 (W.D. Pa. Nov. 8, 2012).

Nebraska: Neb. Rev. Code § 45-1,113.

Nevada: Nev. Rev. Stat. § 111.220(4) ("[e]very promise or commitment to loan money or to grant or extend credit in an original principal amount of at least $100,000 made by a person engaged in the business of lending money or extending credit").

New Mexico: N.M. Stat. Ann. § 58-6-5 ("a contract, promise or commitment to loan money or to grant, extend or renew credit or any modification thereof, in an amount greater than twenty-five thousand dollars ($25,000), not primarily for personal, family or household purpose").

North Dakota: N.D. Cent. Code § 9-06-04(4) ("[a]n agreement or promise for the lending of money or the extension of credit in an aggregate amount of twenty-five thousand dollars or greater").

Ohio: Ohio Rev. Code Ann. § 1335.02(B).

Oklahoma: 15 Okla. Stat. § 140(B) ("[n]o lender or borrower may maintain an action to enforce or seek damages for the breach of any term or condition of credit agreement having a principal amount greater than Fifteen Thousand Dollars ($15,000.00), unless such term or condition has been agreed to in writing and signed by the party against whom it is sought to be enforced or against whom damages are sought").

Oregon: Ore. Rev. Stat. § 41.580(1)(h).

South Dakota: S.D. Cod. L. Ann. § 53-8-2(4).

Tennessee: Tenn. Code Ann. § 29-2-101(b).

Texas: Tex. Bus. & Com. Code Ann. § 26.02(b) ("[a] loan agreement in which the amount involved in the loan agreement exceeds $50,000 in value is not enforceable unless the agreement is in writing and signed by the party to be bound or by that party's authorized representative").

Utah: Utah Code Ann. § 25-5-4(1)(f).

Virginia: Va. Code Ann. § 11-2(9) ("any agreement or promise to lend money or extend credit in an aggregate amount of $25,000 or more"). See Wachovia Bank, National Ass'n. v. Preston Lake Homes, LLC, 2010 WL 4530103 (W.D. Va. Nov. 10, 2010) (statute of frauds prevented borrower from claiming parties implicitly modified loan agreements; if, as borrower contended, both parties understood that development project would take five to seven years to complete and that lender intended to commit to funding project throughout that period, parties were obligated to memorialize this understanding in written agreement, but parties did not do so; instead, parties expressly agreed that construction and acquisition and development agreements would expire prior to the completion date; under Virginia law, borrower could not now claim that explicit terms of loan agreements did not reflect parties' true intentions at time of contract formation, or that parties later implicitly modified contract).

Washington: Wash. Rev. Code § 19.36.110.

These statutes, which supplement pre-existing statutes of frauds, began with three enacted in 1985 in Minnesota, North Dakota, and South Dakota. Most of these statutes, however, became effective only in or after 1989, and they vary widely in scope and requirements.

Two commentators have helpfully summarized seven basic issues which must be explored to ascertain the effect of a particular state statute on a specific lender liability claim. These issues are:

> "(1) What types of agreements [are] covered by the statute?
>
> "(2) [Does] the statute apply both to an agreement and to any changes or modifications to that agreement?[17.2]
>
> "(3) What underlying transactions [are] covered by the statute?
>
> "(4) [Does] the statute apply equally to all lenders and all borrowers?
>
> "(5) What requirements must the written agreement satisfy before an action may be brought upon the agreement?
>
> "(6) What transactions [are] exempt from the operation of the statute?
>
> "(7) [Does] the statute curtail common law means of avoiding a statute of frauds defense and/or alternative legal theories based on the same set of facts alleged in support of a breach of oral contract claim?"[17.3]

Since the answers to many of these questions are not apparent in most states from the face of the statute, the proper interpretation of these statutes may take years of case development on a jurisdiction-by-jurisdiction basis, and the law in each jurisdiction with such a

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[17.2] See, e.g.:

Idaho: Rule Sales & Service, Inc. v. U.S. Bank National Ass'n., 133 Idaho 669, 991 P.2d 857 (Idaho App. 1999) (holding that Idaho Code § 9-505 applies only to original loan commitments, and not to promises of an extension of time for payment).

Kentucky: Farmers Bank and Trust Co. of Georgetown, Ky. v. Willmott Hardwoods, Inc., 171 S.W.3d 4 (Ky. 2005) (statute applies to modifications that materially modify agreement; thus, if time is of essence in loan commitment, agreement to extend time for closing must satisfy statute of frauds).

[17.3] Culhane and Gramlich, "Lender Liability Limitation Amendments to State Statutes of Frauds," 3 Lender Liability News, Part 2, at 10-11 (June 13, 1990). An Appendix to this Article by Mr. Culhane entitled "State Lender Liability Limitation Statutes," reviews and categorizes thirty-one state statutes on these issues.

See, e.g., Walker v. First National Bank of Medicine Lodge, 129 Fed. Appx. 411 (10th Cir. 2005) ("Under Oklahoma law, a borrower may not 'maintain an action to enforce or seek damages for the breach of any term or condition of a credit agreement having a principal amount greater than Fifteen Thousand Dollars . . . , unless such term or condition has been agreed to in writing and signed by the party against whom it is sought to be enforced or against whom damages are sought'").

statute must therefore be checked carefully, with current research into controlling caselaw.[17.4]

[c]—Suggested Documentation Techniques

While the cases which have discussed the enforceability of oral promises to lend have differed in their approach, they yield guidelines for lending which suggest the wisdom of additional documentation when dealing with prospective borrowers. Although the best defense to a claim of an oral promise to lend may seem to be a policy against loan officers making such oral commitments, two considerations suggest that this is not sufficiently protective of the lender's interest. To begin with, aggressive marketing techniques brought about by the erosion of traditional markets by commercial paper, international financing, interstate banking and the emergence of niche lenders make such a policy difficult to implement. In addition, even effective implementation of a no oral commitment policy does not prevent a borrower from exaggerating or inventing a conversation which may give rise to a finding of an oral promise to lend. A more effective technique is to write to the prospective borrower after receipt of a loan application and after the initial meeting or communication about a prospective lending relationship. In the letter, the lender should explain its approval process, including any required committee action, and state that the lender does not make oral commitments, and that no commitment to lend has yet been made. Such letters should also state that no commitment to lend is made unless and until a binding written commitment is issued by the lender and signed and returned by the borrower.[18] If written commitments to lend are not used, the lender's letter should state that no commitment to lend arises until the definitive loan documentation has been signed by both parties. If additional meetings or communications transpire before definitive documents are signed, the nature of any agreements should be confirmed in writing with the borrower and the required approval process should be reiterated.

[2]—Written Commitments

[a]—Liability Arising from Proposals

Lenders must take particular care in corresponding with prospective borrowers on the terms and conditions of a proposed financing

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[17.4] A Model Statute has been drafted by Fred H. Miller and Dean C. Gramlich and is reprinted, with commentary, in Culhane and Gramlich, "Lender Liability Limitation Amendments to State Statutes of Frauds," 3 Lender Liability News, Part 2, at 13-14 (June 13, 1990).

[18] Chrysler Capital Corp. v. Southeast Hotel Properties LP, 697 F. Supp. 794 (S.D.N.Y. 1988).

since such correspondence may be interpreted as imposing a legally binding obligation to make a loan. In one leading case,[19] a letter which the lender characterized as "a mere invitation to negotiate a contract," was held to be a binding commitment because it contained all the essential terms of the lending relationship. Significantly, this conclusion was reached despite language that any commitment was conditioned upon "documentation necessary to effect the transaction being satisfactory in substance and form to all parties."[20] By contrast, other decisions have held commitment letters not binding because they contained conditional language requiring execution of further documentation satisfactory to the lender, or the occurrence of other events.[21]

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[19] Sterling Faucet Co. v. First Municipal Leasing Corp., No. LR-C-80-276 (E.D. Ark. July 30, 1982) (applying Arkansas law), *aff'd* 716 F.2d 543 (8th Cir. 1983).

[20] *Id*., slip op. at 6. See also, Consarc Corp. v. Marine Midland Bank, 996 F.2d 568 (2d Cir. 1993) (applying New York law).

[21] J. Russell Flowers, Inc. v. Itel Corp., 495 F. Supp. 88 (N.D. Miss. 1980). See also:

First Circuit: Crellin Technologies, Inc. v. Equipmentlease Corp., 18 F.3d 1, 7-8 (1st Cir. 1994) (financing agreement conditioned on approval by funding source).

Second Circuit: Philips Credit Corp. v. Regent Health Group, Inc., 953 F. Supp. 482, 513 (S.D.N.Y. 1997) (applying New York law); Chrysler Capital Corp. v. Southeast Hotel Properties LP, 697 F. Supp. 794 (S.D.N.Y. 1988).

Third Circuit: RCN Corp. v. Paramount Pavilion Group, LLC., 164 Fed. Appx. 291 (3d Cir. 2006) (in light of condition attached to bank's loan offer—that prospective borrower put money into escrow or secure letter of credit—it did not constitute a "loan commitment" within meaning of agreement).

Fifth Circuit: Clardy Manufacturing Co. v. Marine Midland Business Loans, Inc., 88 F.3d 347, 352-355 (5th Cir. 1996) (lender's proposal letter outlining financial accommodations lender would be willing to consider held not to be firm commitment to lend even if enumerated due diligence items were completed satisfactorily).

Tenth Circuit: Homestead Golf Club, Inc. v. Valley Bank and Trust Co., 224 F.3d 1195 (10th Cir. 2000) (applying Utah law).

State Courts:

California: SCC Acquisitions Inc. v. Central Pacific Bank, 207 Cal. App. 4th 859, 143 Cal. Rptr. 3d 711 (2012) (term sheet containing the following language did not constitute binding commitment to lend: "Please be advised that this is for discussion purposes only, is subject to Bank approval and should not be construed as a commitment to lend."); Careau & Co. v. Security Pacific Business Credit, Inc., 222 Cal. App. 3d 1371, 272 Cal. Rptr. 387 (1990).

New York: Transit Management, LLC v. Watson Industries, Inc., 803 N.Y.S.2d 860 (N.Y. App. Div. 2005) (although a commitment letter proffered by a lender and accepted by a prospective borrower constitutes an enforceable contract, in this case there was a condition precedent that had to be met to render the commitment letter enforceable; it was undisputed that the debtor did not satisfy this condition precedent—the provision of written confirmation of firm payoff figures for its state and federal tax liabilities—and thus the lender's obligation under the commitment letter never arose).

Even informal correspondence may be construed as a binding commitment to lend. For example, in a leading Ninth Circuit case,[22] a letter from the lender calling on the borrower to submit a loan application and a $25,000 deposit was treated as an agreement[23] to provide financing where, at the borrower's request, the lender had handwritten on the letter terms of "proposed financing" and the borrower then signed the letter.

[b]—Liability From Modifying a Commitment

Once even an informal written commitment is issued, a lender may not be able to add any material conditions in the definitive loan documentation. Thus, in the case described above, a verdict remitted to $925,000 was upheld against the lender for attempting to add a prepayment penalty as a condition of the financing.[24] When the borrower refused to accept the additional condition, it lost an acquisition opportunity since it could not arrange replacement financing in a timely fashion.

[c]—Liability for Breach of a Commitment

Liability for breach of a loan commitment can be quite significant. For example, in one leading case, a Missouri state appellate court affirmed a $70 million jury verdict for a borrower based upon its lender's anticipatory breach of a conditional loan commitment.[25] There, the lender had issued a $65 million conditional loan commitment, which was modified and then accepted by the borrower, a trucking company; the borrower paid a $200,000 good faith deposit for the commitment.[26] The written commitment contained twelve special

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[22] 999 v. C.I.T. Corp., 776 F.2d 866 (9th Cir. 1985) (applying California law).

[23] See *id*, 776 F.2d at 868-869. The lender had admitted in pre-trial pleadings that the letter in question constituted an agreement, although it later attempted unsuccessfully to withdraw this admission.

[24] 999 v. C.I.T. Corp., 776 F.2d 866 (9th Cir. 1985) (applying California law). See also:

California: Hunt v. United Bank & Trust Co., 210 Cal. 108, 291 P. 184 (1930).

New Hampshire: Onway Village, Inc. v. United Savings Bank, No. 89-C-1627 (N.H. Super. Mar. 30, 1990) (attempt to add jury trial waiver not contained in commitment).

[25] Anuhco, Inc. v. Westinghouse Credit Corp., 883 S.W.2d 910 (Mo. App. 1994). *Cf.,* Stanford Square, L.L.C. v. Nomura Asset Capital Corp., 2001 WL 1506012 (S.D.N.Y., Nov. 26, 2001) (to establish anticipatory repudiation under New York law, a plaintiff must identify an "'overt communication of intention' not to perform").

[26] In *Anuhco, Inc*., N.25 *supra,* $133,336.75 was ultimately refunded, the lender retaining a $50,000 fee and the balance being applied to the lender's attorney's fees.

conditions that had to be fulfilled to the lender's satisfaction before it became obliged to fund the loan. The key condition provided that the May 31, 1988 "operating results" of the borrower had to be "found to be in line with projected operating results."

The actual results for the test period were mixed; sales revenues were 12% below the forecast, but the net loss was $400,000 under the projected net loss of $5,400,000. At a meeting with the borrower, the lender claimed it had told the borrower that these results were unsatisfactory to it, but that it would reconsider funding the loan based on the results of the next month. The parties also discussed a prefunding audit and a tentative closing date of July 11 or 12.

The projected June figures were reported to the lender on June 22, and were found to be unsatisfactory. The lender informed the borrower that the loan transaction was "on hold," and could not close in early July, but that it would reconsider funding if additional financial information were supplied, including the final June operating results. No such additional information was supplied by the borrower, which sought other funding but was only partially successful in that endeavor.

On July 5, the borrower issued a press release stating that the financing had been placed "on hold," and that the lender's refusal to close the loan "could jeopardize [the borrower's] insurance coverage, which is currently due to expire on July 11 . . . and working capital, both of which are necessary to continued operations."

On July 11, the lender refused demands for immediate credit. The borrower filed for Chapter 11 bankruptcy protection on August 16.

At trial, the borrower's expert witnesses testified that the July 5 press release caused the bankruptcy; that the borrower had a need for capital to provide cash to operate the business until it returned to profitability; that it would have been a viable company with the proposed financing; and that it "would be alive and well today and a major player" had the funding been received.

The major issues on appeal related to the recovery of consequential damages, which the appellate court upheld in light of expert testimony measuring the value of the borrower's business calculated by evaluation techniques based upon comparable sales and asset value.[27] The court also found these damages to be foreseeable, and permitted the use of the lender's Credit Procedures Manual to show the lender's "awareness of consequences one could reasonably anticipate if it

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[27] The appellate court rejected the use of lost anticipated profits as a basis for recovery as being "unsupported by specific and substantial evidence and constitut[ing] conjecture and supposition."

wrongfully refused to extend a loan after its commitment letter was accepted."[28]

On the issue of liability, the court upheld the use of a jury instruction that required a verdict to be returned for the borrower, *inter alia,* if "plaintiffs either met or could have met the conditions set out in the . . . commitment letter," and "defendant failed to perform its agreement."[29]

[d]—Suggested Documentation Techniques

While documentation techniques cannot foreclose a borrower's contentions that oral representations were made regarding the terms or effect of a commitment, application of the following techniques should be of significant assistance to a lender in arguing that it has no obligation to lend:

(1) The borrower should be requested to sign an acknowledgement that any commitment is not binding on the lender until the execution of the final loan documents;[30]

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[28] This point is discussed in more detail in § 10.03[1][a] *infra,* in which the relevant portions of the Manual are quoted.

[29] For other decisions involving a claim of breach of contract arising out of a commitment letter, see e.g.:

Second Circuit: Sinclair Broadcast Group, Inc. v. Bank of Montreal, 94 Civ. 4677 (S.D.N.Y. Feb. 16, 1995) (applying New York law) (holding on motion to dismiss that withdrawal from loan commitment based on "material adverse change" provision may have been pretextual and therefore in bad faith if the withdrawal was motivated by a $237,500 nonrefundable commitment fee).

State Courts:

Texas: Basic Capital Management, Inc. v. Dynex Commercial, Inc., 348 S.W.3d 894 (Tex. 2011) (real estate management company was entitled to recover consequential damages for breach of $160 million loan commitment).

[30] One commentator has suggested the following language:

> "Borrower acknowledges by its execution of this term sheet in the space provided below that nothing contained in this term sheet shall create a binding obligation on the Lender to consummate the Loan hereunder and that any such obligation may only be created by the execution and delivery by Lender and Borrower of the definitive loan agreement referred to herein."

See also: Brush v. Wells Fargo Bank, N.A., 2012 WL 5989204 (S.D. Tex. Nov. 29, 2012) (applying Texas law) (because lender did not sign, loan modification with following language unenforceable: "[t]his Plan will not take effect unless and until both I and the Lender sign it and Lender provides me with a copy of this Plan with the Lender's signature"); Holmes v. Peoples State Bank, 796 So.2d 176 (La. 2001) (multiple indebtedness mortgage that clearly identified face amount of $156,000 as a "maximum obligation limit" did not constitute promise to loan the full $156,000 maximum limit).

See also, North, "Drafting Loan Documents to Minimize Lender Liability," Lender Liability: Theories and Practice 97, 99-100 (Pa. Bar Institute 1988).

(2) The commitment should set forth all material conditions to the lender's obligation to lend and characterize such conditions as conditions precedent to its obligation to lend. If such conditions are not satisfied by the borrower, no obligation to lend will arise;[31]

(3) Specific conditions precedent which should be considered for inclusion in the commitment letter are the continuing accuracy of any financial statements, covenants, and representations; the provision of adequate collateral and evidence of priority in secured transactions; the signing of specified jury waiver, arbitration or alternative dispute resolution documentation; execution of documentation consenting to prepayment penalties; acceptance of conditions on further advances, and of termination and foreclosure provisions; and the absence of any material adverse change in the borrower's financial condition and business operations;

(4) Merger and integration clauses[32] should be included to bar the introduction of prior oral representations and claimed oral amendments, or waivers of conditions precedent;[33]

But see, Sterling Faucet Co. v. First Municipal Leasing Corp., No. LR-C-80-26 (E.D. Ark. July 30, 1982) (applying Arkansas law), *aff'd* 716 F.2d 543 (8th Cir. 1983), N.19 *supra*.

[31] *Second Circuit:* Penthouse International Ltd. v. Dominion Federal Savings & Loan Ass'n., 855 F.2d 963 (2d Cir. 1988).

Third Circuit: International Minerals & Mining Corp. v. Citicorp North America, Inc., 736 F. Supp. 587 (D.N.J. 1990).

Fourth Circuit: Eaglehead Corp. v. Cambridge Capital Group, Inc., 170 F. Supp.2d 552 (D. Md. 2001) (loan commitment clearly conditioned funding of the loan on lender's approval of a current appraisal of the collateral).

Fifth Circuit: Chambers & Co. v. Equitable Life Assurance Society, 224 F.2d 338 (5th Cir. 1955) (applying Georgia law).

Sixth Circuit: Frank's Nursery Sales, Inc. v. American National Insurance Co., 388 F. Supp. 76 (E.D. Mich. 1974).

Seventh Circuit: Runnemede Owner, Inc. v. Crest Mortgage Corp., 861 F.2d 1053 (7th Cir. 1988).

State Courts:

California: Careau & Co. v. Security Pacific Business Credit, Inc., 222 Cal. App. 3d 1371, 272 Cal. Rptr. 387 (1990); Laks v. Coast Federal Savings & Loan Ass'n., 60 Cal. App. 3d 885, 131 Cal. Rptr. 836 (1976).

Colorado: Concord Realty Co. v. Continental Funding Corp., 76 P.2d 1114 (1989) (reversing judgment of $25,345,104).

Texas: First Texas Savings Ass'n v. Dicker Center, Inc., 631 S.W. 2d 179 (Tex. App. 1982).

Washington: Farm Crop Energy, Inc. v. Old National Bank, 109 Wash. 2d 923, 750 P.2d 231 (1988).

[32] See North, "Drafting Loan Documents to Minimize Lender Liability," Lender Liability: Theories and Practice, 97, 112, 113 (Pa. Bar Institute 1988), for forms of such clauses. See also, § 1.04[2][e] *infra*.

[33] Towers Charter & Marine Corp. v. Cadillac Insurance Co., 894 F.2d 516 (2d Cir. 1990). A lender may waive a condition precedent by not requiring compliance.

(5) A specific expiration date for the commitment should be included, as such a provision may bar arguments that the commitment was extended by continuing negotiations;[34]

(6) Provisions restricting the choice of forum for suits and specifying the governing law should be included;

(7) Since acceptance of a substantial commitment fee is likely to make a court more receptive to finding a binding obligation to lend,[35] lenders should consider the suggestion of one commentator that such fees be limited to cover only the lender's out of pocket expenses, and that the commitment recite this;[36] and

(8) Given the tendency of courts to read good faith obligations into commitment letters and to bind the borrower as well as the lender,[37] the commitment should include a requirement that the borrower execute all documents and perform such other acts as may reasonably be required by the lender.

See, e.g., Hidalgo Properties, Inc. v. Wachovia Mortgage Co., 617 F.2d 196 (10th Cir. 1980) (applying Oklahoma law).

See also:

Indiana: Illiana Surgery & Medical Center, LLC. v. STG Funding, Inc., 824 N.E.2d 388 (Ind. App. 2005).

Montana: First Security Bank v. Abel, 343 Mont. 313, 184 P.3d 318 (Mont. 2008) (giving effect to a provision that read "[n]o modification of this agreement may be made without [the Bank's] express written consent").

New York: Opton Handler Gottlieb Feiler Landau & Hirsch v. Patel, 203 A.D.2d 72, 610 N.Y.S.2d 26 (N.Y. App. Div. 1994).

[34] *Second Circuit:* Penthouse International, Ltd. v. Dominion Federal Savings & Loan Ass'n., 855 F.2d 963, 966 (2d Cir. 1988) (refusing to consider lender's actions taken after expiration date of commitment, which contained a provision that the commitment would "expire one hundred twenty (120) days after the date hereof (the 'Commitment Expiration Date') unless mutually extended in writing by Lender, and upon such expiration Lender shall have no further obligation to Borrower. . . .").

State Courts:

Colorado: Concord Realty Co. v. Continental Funding Corp., 776 P.2d 1114 (1989).

Kentucky: Farmers Bank and Trust Co. of Georgetown, Kentucky v. Willmott Hardwoods, Inc., 171 S.W.3d 4 (Ky. 2005).

[35] *Ninth Circuit:* 999 v. C.I.T. Corp., 776 F.2d 866 (9th Cir. 1985) ($25,000 deposit), discussed at Ns. 22-24 *supra*.

State Courts:

Missouri: Shaughnessy v. Mark Twain State Bank, 715 S.W. 2d 944 (Mo. App. 1986).

[36] See Poscover, "Lender Liability—Avoidance Techniques," IV Emerging Theories of Lender Liability 101, 135, 137 (1987). See also:

Tenth Circuit: Gilmore v. Ute City Mortgage Co., 660 F. Supp. 437 (D. Col. 1986).

State Courts:

California: Careau & Co. v. Security Pacific Business Credit, Inc., 222 Cal. App. 3d 1371, 272 Cal. Rptr. 387, 395, n.12 (1990).

[37] *Second Circuit:* Teachers Insurance & Annuity Ass'n. v. Butler, 626 F. Supp. 1229 (S.D.N.Y. 1986), *dismissed memo*. 816 F.2d 670 (2d Cir. 1987).

State Courts:

Florida: Bluevack, Inc. v. Walter E. Heller & Co., 331 So.2d 359 (Fla. App. 1976).

§ 1.04 Structuring the Loan Agreement[1]

[1]—Introduction: A Note on the Limits of Documentation

Many lender liability problems can be avoided by careful loan documentation that clearly spells out the obligations of the parties, as well as any conditions relating to their respective performance. In addition, effective loan documentation provides a precise method for dispute resolution, protecting the legitimate rights of both parties. By dealing with these issues at the beginning of the lending relationship, later problems are eliminated and less room is permitted for arguments that one party possessed certain rights, or was owed certain duties, which are not set forth in the loan agreement.

In this section, common drafting problems are reviewed both in the context of the parties' monetary rights and obligations, and in the equally significant area of dispute resolution. In both areas, careful drafting can eliminate or minimize many possible lender liability dangers, and drafting suggestions are set forth for dealing with several recurring problems.

Lenders must nevertheless be cautious to avoid the perception that every area of potential liability can be eliminated by proper documentation.[1.1] Such an attitude leads to the exaction of oppressive and ultimately unenforceable provisions, particularly in those jurisdictions which recognize a broad duty of good faith and fair dealing.[2] Including such provisions may also lead to emotional backlash by judge and jury alike, and both may come to see the lender as imposing unreasonable and unconscionable terms and conditions on an oppressed borrower.

A second and equally dangerous consequence of overdocumentation is the prospect that the lender's written powers over the affairs of the borrower may be perceived as so extreme as to persuade the trier of fact to conclude that the lender controls the borrower, and therefore is responsible to third parties for the borrower's obligations, or should have its loans subordinated to debts owed to other creditors.[3]

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[1] The Loan Agreement Litigation Checklist contained in Appendix A *infra* provides a vehicle for reviewing proposed loan documentation to pinpoint places for further clarification.

See also, e.g., Lee, "Bank Loan Documentation—Practical Tips for Review, Issue Spotting and Negotiation," 1295 PLI/Corp 457 (March 2002) (outlining the structure of a typical major U.S. bank loan agreement).

[1.1] See, e.g., Eisel v. Midwest BankCentre, 2006 WL 3408185 (Mo. App. Nov. 28, 2006) (bank engaged in unauthorized business of law when it charged separate fee for creating deeds of trust and loan documentation).

[2] See § 5.03 *infra*.

[3] See Chapter 6 *infra*.

Including provisions which grant broad powers over such items asvoting the borrower's stock, or taking possession of its books and records, or granting the lender veto powers over management changes, sales and inventory policies, personnel hiring, firing, and compensation, or the payment of certain debts, each must be evaluated carefully in the particularized context of a specific relationship. The need for each such provision should be balanced against the danger that it may be viewed as a link in a chain of evidence leading to the conclusion that the lender controls the borrower.

[2]—Defining the Parties' Monetary Rights and Obligations

[a]—Right to Payment on Demand

Even when a borrower signs an instrument obligating it to repay a loan on demand, courts will often refuse to enforce the lender's apparent right to immediate payment, without a prior period of notice.[4] This happens principally in three contexts:

(1) Some courts have held that any right to make a demand for immediate repayment is conditioned by a general duty of good faith and fair dealing.[5]

(2) Other courts have held that a lender may enforce a demand clause only on a pure demand instrument. When the underlying documentation consists of more than a simple promissory note, these courts will find that the specification of events of default, conditions on acceleration or termination, or other contingencies, is inconsistent with a pure demand obligation. The lender's right to demand repayment is thereby rendered conditional, limited both by the terms and conditions set forth in the loan documentation, and by a general obligation of good faith and fair dealing.[6]

(3) A lender's course of dealing may result in waiver of any demand feature under particular factual scenarios when the lender has acquiesced in certain actions by the borrower.[7]

Given these exceptions, before drafting a demand instrument, lenders must carefully consult the laws of the various jurisdictions whose substantive law may apply.[8] When the controlling substantive law will not unconditionally enforce a demand feature because of an

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[4] See § 5.03 *infra*.
[5] See § 5.03[2][b][i] *infra*.
[6] See § 5.03[2][b][ii] *infra*.
[7] See §§ 5.03[3][b][i],[iii]-[v] *infra*.
[8] The potential enforceability of a demand obligation is one of many factors to be considered in specifying the governing substantive law under a choice of law provision in the loan documentation. See § 1.04[3][e] *infra*.

overriding obligation of good faith, lenders have no realistic drafting recourse and must instead carefully evaluate whether notice must be given to the borrower before taking action in a particular case. In those jurisdictions in which only pure demand instruments will be enforced, lenders typically will not wish to lend solely on a promissory note, since the realities of the lending relationship, at least on most commercial loans, will require specifying various contingencies and events of default. One commentator has suggested including the following language to preserve the lender's right to immediate repayment in situations in which events of default are specified in the loan documentation:

> "Notwithstanding anything to the contrary contained herein, Lender may, at any time in its sole discretion, demand repayment of all demand loans made to Borrower hereunder whether or not any Event of Default, or any event which, with the giving of notice or the passage of time or both, would constitute an Event of Default shall have occurred. The Events of Default described in Section ___ hereof shall not be construed to limit in any manner the Lender's ability to demand repayment of the Loan at any time."[9]

A third class of cases in which payment on demand clauses may not be enforced involves oral representation, course of dealing and waiver issues. In these cases, documentation may be helpful in negating such defenses.[10]

[b]—Interest Rate Provisions

To express accurately the agreement of the parties on interest rate, special care must be taken in three areas. These are (1) properly defining the prime rate of interest, where that index is employed, (2) properly defining the terms and conditions for the use of other interest rate indices, and (3) clarifying the method of computing the interest rate.

(Text continued on page 1-19)

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[9] North, "Drafting Loan Documents to Minimize Lender Liability," Lender Liability: Theories and Practice 97, 103 (Pa. Bar Institute 1988). See also, Bankers Trust Co. v. Poskanzer, 90 Civ. 0627 (WK) (S.D.N.Y. July 10, 1990) (granting summary judgment to lender collecting on note and rejecting borrower's claim of oral modification; note provided, in all capital letters, that "It is understood and agreed that the provisions contained in this note and in the letter agreement are matters of contractual agreement and shall in no way be deemed to detract from or diminish in any way the demand nature of this note, and the undersigned agrees that the Bank may at any time demand payment of this note in its discretion, notwithstanding any compliance or noncompliance by the undersigned therewith").

[10] This topic is discussed in § 1.04[2][e] *infra*.

[i]—"Prime Rate" Issues

Starting in the early 1980's, many borrowers whose loans were pegged to the prime rate of interest began to sue their lenders on a variety of theories based on the premise that a lender's published "prime rate" should be its lowest and best rate to its commercial borrowers.[11] These suits were nourished by faulty documentation which had failed to keep pace with fundamental changes in the financial marketplace in the late 1970's. At that time, the greatly expanded use of commercial paper, combined with the entry of foreign banks as significant commercial lenders to domestic borrowers and increased domestic competition for the business of large corporate borrowers, caused many domestic lenders to utilize alternate interest rate indices on a large scale. Interest rates for such borrowings were based on indices such as the certificate of deposit rate, the London Interbank Offered Rate ("LIBOR"), or a federal funds rate. The availability of such alternate rates, in turn, often resulted in large corporate borrowers which chose financing vehicles utilizing such indices receiving sub-prime interest rates.

In this context, the classic definition of a lender's "prime rate of interest" as that rate charged to a bank's "largest and most credit worthy commercial customers on new ninety-day unsecured loans" was attacked as fraudulent, and the exaction of "prime" interest rates in excess of the rates charged under these alternate indices claimed to be a breach of contract.[12] Some borrowers even contended that the undefined use of the term "prime rate," such as in a promissory note, was misleading since the prime rate was commonly understood to be a lender's lowest commercial rate.[13]

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[11] See § 4.02[2] *infra.* See generally, Mannino, "Prime Rate Overcharge Cases: How to Exorcise The RICO Devil," 101 Banking L.J. 196 (1984).

[12] See American Bar Association, *Term Loan Handbook* § 4.3 n. 83, at 38-39 (1983). While the standard definition of the prime rate in general use in the late 1970's did not characterize it as the bank's lowest or best interest rate to large corporate borrowers, some lenders did take this extra step. See, e.g., Michaels Building Co. v. Ameritrust Company, N.A., 848 F.2d 674, 676 n. 2 (6th Cir. 1988) (prime rate defined as "the best rate of interest generally charged by Bank for unsecured short term commercial loans to the most credit-worthy commercial borrowers.") (Ohio law).

[13] Borrowers generally relied both on popular dictionary definitions, see, e.g., Michaels Building Co. v. Ameritrust Company, N.A., 848 F.2d 674, 676 n. 2 (6th Cir. 1988) (quoting American Heritage Dictionary definition of prime rate as "[t]he lowest rate of interest on bank loans at any given time and place, offered to preferred borrowers."), and on definitions taken from specialized financial publications, see, e.g., American Bankers Ass'n, *Banking Terminology* 193 (1981) (referring to rate charged to a bank's "most credit-worthy customers," and characterizing prime as a bank's "minimum rate of interest for preferred customers"); Standard & Poor's Corp., *A Glossary of Financial Investment Terms* (1977) ("the best rate any borrower can obtain at any given time").

In reaction to these lawsuits, lenders have adopted several approaches. Some have chosen to eliminate the use of the term "prime rate" altogether, adopting other nomenclature such as "base" or "published" rate, and defining such terms as "that rate so designated and established by the bank, as such rate may change from time to time." Other lenders have retained the prime rate terminology, utilizing the same or similar definitions. Some of these lenders have also included the parenthetical notation "not necessarily the lowest rate charged by the bank" as further notification to the borrower that it may not be receiving the lender's lowest commercial rate. This last approach is the most prudent to avoid litigation over the meaning of the term "prime rate," although the widespread publicity surrounding years of prime rate litigation makes it difficult for any current borrower to claim that it was misled into believing that its lender's "prime rate" was its lowest commercial rate.

While these revised definitions are both helpful and necessary to avoid litigation, lenders should not assume that they possess unbridled discretion to charge whatever interest rate they deem appropriate at any given time. Thus, one court has held that the common law duty of good faith and fair dealing may require a lender which uses the old definition of prime rate to calculate its interest rate by estimating in good faith the lowest interest rate it expects to offer on ninety-day loans to commercial customers.[14] The grounds upon which the court

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See also Lum v. Bank of America, 361 F.3d 217 (3d Cir. 2004) (plaintiffs argued that the term "prime rate" is so generally understood to mean the lowest rate available to a bank's most creditworthy borrowers that the failure to disclose that some borrowers obtain loans with interest rates below the prime rate constitutes fraud; court held, however, that even drawing every reasonable inference in favor of plaintiffs, the meaning of the term "prime rate" is sufficiently indefinite that it is reasonable for the parties to have different understandings of its meaning, citing a congressional committee staff report [Staff of House Comm. on Banking, Finance and Urban Affairs, 97th Cong., 1st Sess., "An Analysis of Prime Rate Lending Practices of the Ten Largest United States Banks" 3 (Comm. Print 1981)] that described "prime rate" as a "'murky, ill-defined term that rarely reflects the lowest rates available to corporate customers'").

[14] Kleiner v. First National Bank, 581 F. Supp. 955, 960 n. 5 (N.D. Ga. 1984) (applying Georgia law). See also:

Seventh Circuit: Haroco, Inc. v. American National Bank & Trust Co., 38 F.3d 1429, 1436 (7th Cir. 1994) ("Allowing the bank to set its prime rate as an estimate vests them with some degree of unilateral discretion in carrying out its contractual obligation. In such a case the common law duty of good faith and fair dealing requires that the bank exercise that discretion 'reasonably, not arbitrarily, capriciously, or in a manner inconsistent with the expectations of the parties.'").

State Courts:

Maryland: Riggs National Bank v. Webster, 832 F. Supp. 147, 152 (D. Md. 1993) (bank's discretion to set its prime rate not unfettered; "[a]ll that the bank must do is to set its prime rate after a deliberative process in which objective factors, extraneous to the specific loan made to the Websters, are considered and to use the same prime rate in calculating the interest under all notes on which its 'Prime Rate' is used as the basis").

found such a possible good faith obligation to arise in calculating a lender's prime rate apply equally to the revised definitions now in use, since the court reasoned that "[a]rguably, where an agreement permits one party to unilaterally determine the extent of the other's required performance, an obligation of good faith in making such a determination is implied."[15]

[ii]—Issues Arising Under Other Interest Rate Indices

With the advent of new interest rate indices whose terms and conditions are not well understood by any but the most experienced borrowers, lenders utilizing such indices must be careful to set forth clearly the terms and conditions relating to the use of such indices, particularly

(Text continued on page 1-21)

Pennsylvania: LeBourgeois v. Firstrust Savings Bank, 27 Phila. 42, 63-67 (Comm. Pleas 1994) (bank's discretion in selecting an index on which adjustable mortgage rate was based was limited by obligation of good faith). See § 5.03[3][b][vi] *infra.*

[15] *Id.*, 581 F. Supp. at 960.

when they depart from customary practices used in traditional fixed or prime rate lending. Some of the more important points to clarify include the following:

(1) The number of interest rate options available to the borrower at any given time. Many agreements now provide at least the three options of a prime or base rate, a certificate of deposit ("CD") rate and a Eurodollar rate.

(2) The specific period for each borrowing on each such index. This is important to the lender, which, with respect to Eurodollar and similar borrowings, is (at least theoretically) purchasing the funds themselves to fund the particular borrowing.

(3) The minimum amount for each borrowing and the maximum number of advances which may be made to the borrower in any given period(s). This is required both to protect the lender as purchaser of the funds, and to ameliorate administrative burdens.

(4) The specification of a maximum interest rate. Since the interest rate payable under several alternate indices does not change, it is prudent to specify an alternate maximum interest rate above which the borrowing may not go, in order to avoid usury and related problems.

(5) The amount, and the form of notice which must be given by the borrower, for each borrowing under each index. Again, such provisions are necessary to insure adequate time for the lender to fund the borrowing, and for administrative convenience.

(6) The specification of the consequences of failure to give timely notice at the end of a borrowing period, regarding the interest rate option for any subsequent period. Here, many lenders require a conversion of the borrowing to a prime or base rate borrowing.

(7) The specification of how the interest rate is computed. Whether LIBOR, a CD rate, or some other reference point is utilized, it is important to define how this reference point is to be calculated. For example, there is no CD market as such, and lenders will customarily calculate a CD rate by obtaining quotes from dealers for the same principal amount and time period of borrowing as are involved in the particular financing. This practice needs to be made clear to avoid charges of fraud and breach of contract from borrowers who may claim that an insufficient number of dealers was contacted, or that those contacted lacked sufficient expertise or independence in the field. In any event, lenders will

probably be held to the same good faith standard in determining the CD rate as mentioned previously in connection with determining the prime rate of interest.

(8) The conditions under which the lender may withdraw the credit facility. Typically, to prevent a loss of their forecast profit margin, lenders will include provisions requiring repayment of a borrowing or its conversion to a prime or base rate loan if the lender's costs change to eliminate its profit margin.

(9) The specification of any prepayment penalty. This is customarily included to indemnify the lender from any loss incurred from locking in funds for a given period to fund a borrowing which is repaid earlier than the corresponding purchase of funds by the lender.

[*iii*]—*Method of Computing Interest Rate.* There are three principal methods for computing interest payments.[16] Two of these—the actual (365/365) and the bond (360/360) bases—create no legal problems. By contrast, the third or bank (360/365) basis, has been challenged on usury,[17] breach of contract,[18] RICO,[19] and truth-in-lending[20] grounds. Under the bank basis of calculating interest:

"The interest rate is divided by 360 days (30 days for each month) to create a daily factor. The number of days that a loan is outstanding is then multiplied by this daily factor. Thus interest charged for months of different lengths is different and interest charged

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[16] See generally, Comment, "Legal Aspects of the Use of 'Ordinary Simple Interest'," 40 U. Chi. L. Rev. 141 (1972).

[17] *Ninth Circuit:* American Timber & Trading Co. v. First National Bank, 511 F.2d 980 (9th Cir. 1973), *cert. denied* 421 U.S. 921 (1975) (held usurious).

Eleventh Circuit: Morosani v. First National Bank, 539 F. Supp. 1171 (N.D. Ga. 1982) (held not usurious).

State Law:

Illinois: Koos v. First National Bank, 358 F. Supp. 890, 892 (S.D. Ill. 1973), *aff'd* 496 F.2d 1162 (7th Cir. 1974) (applying Illinois law) (claim dismissed as "clearly a trifle").

[18] *Eleventh Circuit:* Kleiner v. First National Bank, 581 F. Supp. 955, 961-963 (N.D. Ga. 1984) (plaintiffs' summary judgment motion denied).

State Law:

New Jersey: Silverstein v. Shadow Lawn Savings & Loan Ass'n, 51 N.J. 30, 237 A.2d 474 (1968) (directing entry of judgment for borrowers).

[19] Morosani v. First National Bank, 703 F.2d 1220 (11th Cir. 1983).

[20] Haas v. Pittsburgh National Bank, 60 F.R.D. 604, 610-611 (W.D. Pa. 1973).

for a calendar year is greater than interest charged under either the 365/365 or 360/360 methods."[21]

Eighty-two percent of the banks responding to a 1971 Federal Reserve Study admitted using the 360/365 basis on some loans, and about 45% of the banks using this method did so without disclosure, even though the effect of this method is to increase the interest charge by 1/72.[22] Despite this widespread usage, those courts which have considered the issue have found that the bank basis of calculating interest had not attained the status of a trade usage and custom which is read into loan agreements.[23] As such, these courts have found breach of contract claims to be viable when the bank basis was used to calculate interest, but was not disclosed in the loan documents.

In order to avoid attacks on the use of the bank basis for calculating interest payments, most lenders now disclose the use of the 360/365 method by language such as "interest payable at the rate of X% per annum calculated on the actual number of days elapsed at a daily rate based upon a year of 360 days." While this language has not yet received judicial approval, it seems appropriate to satisfy the concerns expressed by the courts which have considered the various issues raised by use of the bank basis for calculating interest payments.

[c]—Discretionary Advances. The obligation of a lender to initially fund, and thereafter to make further advances under a loan agreement, is usually made conditional on the fulfillment of certain conditions precedent. Most typically, further advances are conditional on at least the following:

(1) The continuing accuracy of any representations and warranties made by the borrower in the loan agreement;

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[21] American Timber & Trading Co. v. First National Bank, 511 F.2d 980, 982 n. 1 (9th Cir. 1973), *cert. denied* 421 U.S. 921 (1975).

[22] See Comment, "Legal Aspects of the Use of 'Ordinary Simple Interest'," 40 U. Chi. L. Rev. 141, 142 (1972).

[23] *Ninth Circuit:* American Timber & Trading Co. v. First National Bank, 511 F.2d 980 (9th Cir. 1973), *cert. denied* 421 U.S. 921 (1975).

Eleventh Circuit: Kleiner v. First National Bank, 581 F. Supp. 955, 961-963 (N.D. Ga. 1984).

State Law:

New Jersey: Silverstein v. Shadow Lawn Savings & Loan Ass'n, 51 N.J. 30, 237 A.2d 474 (1968).

(2) Continued compliance with any covenants undertaken by the borrower in the loan agreement;

(3) The absence of any defaults or events of default;

(4) The absence of any bankruptcy proceedings involving the borrower; and

(5) The absence of any material adverse change in the borrower's business or financial condition.

While the loan agreement may thus condition the lender's continuing obligation to fund a loan, some courts have nevertheless held that a lender violates its duty of good faith and fair dealing if it refuses further advances, without advance notice, when a reasonable lender would not refuse to fund in the same or similar circumstances.[24] Under these decisions, a lender must give advance notice if it decides not to make further advances when it is fully secured, unless it has a valid business reason for acting without prior notice.

To retain the maximum flexibility with respect to future advances, a lender should include several provisions in its loan documentation. First, an express reservation of its discretionary right to fund or refuse to fund should be included. While this will not be controlling in jurisdictions which impose a broad obligation of good faith on lenders, it will remove any borrower argument that it was unconditionally entitled to funding in the absence of a material breach. Second, when such an express reservation of discretion to make further advances is included, lenders must consider providing for refunding all or part of any significant commitment fee, or limiting any fee to amounts sufficient to cover administrative, general overhead, and similar expenses, in the event of a refusal to make future advances.[25]

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[24] See § 5.03[3][b][i] *infra.*

[25] See: North, "Drafting Loan Documents to Minimize Lender Liability," Lender Liability: Theories and Practice 97, 102 (Pa. Bar Institute 1988); Poscover, "Lender Liability—Avoidance Techniques," IV Emerging Theories of Lender Liability 101, 135, 137 (1987); Gilmore v. Ute City Mortgage Co., 660 F. Supp. 437 (D. Col. 1986)

North suggests the following language for what is characterized as an "Administrative Fee":

"The Administrative Fee shall compensate Lender for its efforts in structuring, processing and approving the transactions described herein including, without limitation, its administrative, out-of-pocket, general overhead and lost opportunity costs, but not including any expenses for which Borrower has agreed to reimburse Lender . . . The Administrative Fee shall be fully earned upon the execution of this Agreement and shall not be subject to proration or rebate in the event Lender exercises its discretion not to make advances hereunder or exercises its

Third, lenders should carefully draft the conditions precedent to further advances to impose objective conditions as far as possible, and to spell out the reasons why such conditions are included. For example:

(1) When the continuing accuracy of representations and warranties made by the borrower is a condition precedent to further advances, the loan agreement should recite that such representations and warranties are made by the borrower to induce the lender to make the loan, and that the lender would not have made the loan, and has no duty to make further advances, if the representations and warranties were or are untrue.

(2) Certain representations and warranties, covenants, and events of default are more capable of being specified in objective criteria than others. Requiring representations that there are no liens on the borrower's properties other than those disclosed, and that the borrower's financial statements fairly present its financial condition and disclose all of the borrower's obligations, are more likely, in the event of inaccuracy, to serve as a legitimate basis for a refusal to fund than are breaches of representations that the borrower has complied with all laws and has fully disclosed all facts material to its business. Similarly, specifying as events of default a failure to pay principal or interest, the filing of bankruptcy proceedings, or a failure to discharge a final judgment within a specified period are more likely to be viewed as legitimate reasons for refusing further advances than are problems perceived under insecurity clauses. While both objective and subjective clauses may be included, a lender must be sensitive that the latter may well require provision of advance notice and permitting the borrower a reasonable time to secure replacement financing before further advances may be refused.

(3) When management change, financial ratios and similar clauses are included, the loan agreement should recite both why such items are financially significant, and also that the loan would not have been made in the absence of certain key management personnel or under different financial ratios, and that the lender has

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right to terminate this Agreement." North, Lender Liability: Theories and Practice at 102.

no duty to make further advances when changes in those personnel or ratios occur.[26]

(4) When continued compliance with covenants is made a condition precedent to further advances, lenders must distinguish between the breach of a negative covenant, such as those prohibiting mergers or sales of stock or of substantially all of a borrower's assets, and the breach of an affirmative covenant, such as those requiring the provision and updating of financial information. Typically, only the breach of a negative covenant will justify an immediate refusal of further advances, although the breach of some affirmative covenants, such as the agreement to pay all taxes and debts as they become due, may justify a refusal to advance funds until the covenant is complied with.

(5) Lenders must be careful to apply uniform policies in funding loans and in dealing with events of default and breaches of representations, warranties and covenants. Loan Policy Manuals and training materials should enunciate policies and practices consistent with prudent lending practices for lenders to follow in such circumstances.

(6) Lenders must carefully distinguish between circumstances in which further funding may be refused without advance notice and those in which a refusal to make further advances may be implemented only after a reasonable prior period of notice, when the underlying default or breach has not been corrected. Typically, courts in strict good faith jurisdictions will require advance notice of thirty days, absent an immediate threat of impaired capacity to repay a loan, before a lender will be permitted to refuse a further advance in the case of most borrower breaches.

[d]—Events of Default. Events of default are among the most important provisions in any loan agreement, since a default triggers a lender's rights to terminate its obligation to lend and to take such extraordinary actions as acceleration of the entire debt and foreclosure. Therefore, lenders must be careful both in drafting default provisions and in choosing to exercise their remedies upon default.

While loan agreements may have other events of default crafted to the particular business environment of the specific borrower, most

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[26] See Poscover, "Avoidance Techniques: Lenders Can Still Use Management Change Clauses," 1 Lender Liability Law Rep. 5, 6 (June 1988).

loan agreements will include at least the following standard events of default:

(1) failure to timely pay principal or interest,
(2) failure to pay or otherwise discharge a final judgment in excess of a stated, material amount,
(3) filing of bankruptcy proceedings or taking of comparable action by the borrower or by one of its other creditors,
(4) defaults under other agreements,
(5) failure to observe or perform any covenant,
(6) breach of a representation or warranty,
(7) submission of any false or misleading information to the lender, and
(8) material adverse change in the financial condition of the borrower.

Such events of default may conceptually be divided into three categories. The first three events listed above should in most cases, after the lapse of any permissable cure period, justify the exercise of default remedies since they are both objective and directly and immediately related to the lender's legitimate concerns regarding repayment of its loan.

By contrast, the remaining events of default have caused some courts reviewing incidents of their use to impose limitations on their invocation as a basis for exercising such remedies as acceleration or foreclosure.[27] These remaining events of default may be divided into two categories. The last listed, relating to a material adverse change in the financial condition of the borrower, is usually treated as an insecurity clause which, under Section 1-208 of the Uniform Commercial Code, may serve as a basis for acceleration or for requiring additional collateral only when the lender has a good faith belief that "the prospect of payment or performance is impaired."[28]

The remaining events of default listed above fall between these two relatively clear categories, with some courts requiring the same good faith belief required for insecurity clauses regarding impaired prospects for repayment before default remedies may be exercised for these events of default.[29]

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[27] See § 5.03[3][b][ii]-[iv] *infra.*
[28] See § 5.03[3][b][ii] *infra.*
[29] *Ibid.*

Given the reluctance of some courts to permit the exercise of default remedies for many customary events of default, lenders should be careful to maximize their rights in documenting a loan by taking the following steps:

(1) As with provisions relating to discretionary advances,[30] the lender should recite in the loan agreement the financial bases for events of default relating to covenants and representations. The lender should also specify those historical financial and management facts which induced it to make the loan, changes in which the borrower acknowledges will legitimately permit the lender to withdraw from its commitment to lend.

(2) With respect to those events of default relating to defaults under other agreements, submission of false or misleading information, and material adverse changes, the lender should identify specific key factors which the borrower acknowledges in the loan agreement are critical to the lender's continued obligation to lend. These factors will include such items as:

(a) financial defaults involving a specific, material sum under other agreements which are not cured within a short grace period;

(b) failure to notify the lender regarding CERCLA or ERISA violations or enforcement proceedings relating to claimed violations of those statutes, with their potential for ruinous liabilities;

(c) failure to notify the lender regarding liens of a specific material nature on identified key assets, or of the institution of criminal, class action or derivative litigation involving claims of management wrongdoing or involving specific, material exposures, either criminal or civil in nature, such as prejudgment seizure of assets under the Racketeer Influenced and Corrupt Organizations Act ("RICO") or threatened delisting of securities;

(d) loss of specifically identified key permits, licenses, trade secrets, or personnel;

(e) changes in specific financial ratios which were met in the normal course of business at the inception of the lending relationship and were expected, and acknowledged by the borrower to continue; and

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[30] See § 1.04[2][c] *supra.*

(f) extraordinary economic events such as labor strikes of a specified duration, or loss of a specific key customer or supplier without replacement within a stated period.

(3) With the inclusion of such specifically identified factors, the lender is more likely to be permitted to exercise default remedies. General references to "other material adverse changes" or "failure to submit other material information" to the lender should therefore be retained, since they become more likely to be accorded independent weight where they are invoked in the case of an unanticipated materially adverse event.

While these drafting suggestions should assist lenders, two additional points should be kept in mind before deciding whether to invoke a default remedy.

(1) Lenders must always consider alternatives to invoking default remedies, including a refusal of further advances or requests for additional collateral upon the occurrence of an event of default. However, the loan agreement should not require such actions prior to the exercise of a default remedy; and

(2) Lenders must further keep in mind that courts imposing the strictest limitations upon the exercise of default remedies will expect the lender to prove both the materiality of any default,[31] and the reasonable likelihood that the specific default(s) at issue will impair the lender's prospect of repayment, as well as to demonstrate why a period of notice could not be given prior to acceleration of the entire debt or foreclosure.

[e]—Integration Clause

A common theme of borrowers in many lender liability cases is that their lenders have made oral representations that they would not invoke remedies provided them in the loan agreement, or that they would continue funding under terms and conditions inconsistent with the loan documentation.[32] While an integration provision will not bar

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[31] Where a delay of a day or two in making an interest payment will create an actual threat of impaired prospects for repayment, the loan documentation should both recite and explain this, and further include a time is of the essence provision. *Compare*, Sahadi v. Continental Illinois National Bank & Trust Co., 706 F.2d 193 (7th Cir. 1983), discussed in § 5.03[3][b][iv] *infra*.

[32] *Second Circuit:* Bankers Trust Co. v. Poskanzer, 90 Civ. 0627 (WK) (S.D.N.Y. July 10, 1990).

Fourth Circuit: Dominion Bank, N.A. v. Moore, 688 F. Supp. 1084 (W.D. Va. 1988) (borrower's claim that lender orally agreed not to call demand note for several years held barred by parol evidence rule).

evidence of all the alleged oral representations, incorporating an integration clause in each loan agreement, including amendments, will significantly assist lenders to defeat such claims in many cases.[33] The potentially determinative significance of including a properly drafted integration clause is apparent from two cases decided under California and Connecticut law. In the California case, an appellate court relied heavily upon the presence of an integration clause in reversing a judgment entered on a jury verdict of more than $27 million in favor of borrowers who claimed that the lender had breached an oral promise to extend them a $ two million line of credit.[33.1] Even more dramatically, a federal district judge applying Connecticut law vacated his previous entry of a preliminary injunction in favor of a borrower upon reconsideration, finding that the presence of an integration clause in the loan documentation compelled the denial of the borrower's claims, barring its arguments based upon an alleged course of dealing.[33.2]

Sixth Circuit: Pressman v. Franklin National Bank, 384 F.3d 182 (6th Cir. 2004) (merger and integration clause contained in commitment letter precluded plaintiff from relying upon alleged representations concerning conditions of loan made prior to execution of commitment letter).

State Courts:

Alabama: Pavco Industries, Inc. v. First National Bank, 534 So.2d 572 (1988).

Illinois: The Delcon Group, Inc. v. Northern Trust Corp., 187 Ill. App. 3d 635, 543 N.E.2d 555 (1989).

New York: General Bank v. Mark II Imports, Inc., 741 N.Y.S.2d 201, 293 A.D.2d 328 (2002) (claims of corporate borrower and guarantors that they were fraudulently induced to enter into lending relationship by plaintiff's promise to eliminate the "borrowing cap" on advances to the borrower was, as a matter of law, foreclosed by integration clause of agreement).

[33] See generally, § 8.02[2] *infra*.

[33.1] Banco Do Brasil, S.A. v. Latian, Inc., 234 Cal. App. 3d 973, 285 Cal. Rptr. 870 (1991), *review denied* No. S023696 (Cal. Jan. 23, 1992), *petition for cert. filed* April 22, 1992.

[33.2] B.P.G. Autoland Jeep-Eagle, Inc. v. Chrysler Credit Corp., 799 F. Supp. 1250 (D. Mass. 1992), vacating prior opinion of November 26, 1991.

See also:

Third Circuit: D'Argenzio v. Bank of America Corp., 2012 WL 2839598 (D. N.J. July 9, 2012) (applying New Jersey law) (lender did not fraudulently induce borrowers as borrowers would have suffered same harm had they received refinancing); Freedom Medical, Inc. v. Royal Bank of Canada, RBC, 2005 WL 3597709 (E.D. Pa. 2005) (under Pennsylvania's parol evidence rule, claims for fraudulent inducement are barred when the contract contains a valid integration clause).

Sixth Circuit: Helton v. American General Life Insurance Co., 2010 WL 2889666 (W.D. Ky. July 21, 2010) (although merger and integration clauses do not per se bar fraud claims, party may not rely on oral representations that conflict with written disclaimers to contrary that complaining party earlier specifically acknowledged in writing; thus, when terms of loan agreements directly contradicted supposed misrepresentations of bank officials that insurance premium loans would be continuously renewed, plaintiffs could not show that they justifiably relied on alleged misrepresentations, and their fraudulent inducement claim failed as matter of law).

An integration clause is designed to have the parties acknowledge that a particular written instrument or series of instruments represents the entire and sole evidence of the terms and conditions of their agreement. As such, each written agreement should contain an integration clause with the following acknowledgments:

(1) The written agreement contains the entire agreement of the parties;

(2) The written agreement supercedes any previous agreement(s), written or oral;

(3) Neither party has made any representation, warranty or covenant not contained in the written agreement;

(4) The written agreement may be modified, supplemented or otherwise changed, in whole or in part, only by a written instrument duly signed and executed by designated officers of both parties;

(5) The written agreement may not be modified, supplemented or otherwise changed, in whole or in part, by any waiver, oral representation or course of dealing; and

(6) No delay or failure to exercise any right, power or remedy by the lender shall constitute a waiver of any default, or an acquiescence therein, nor shall it constitute a waiver or acquiescence in similar or future defaults.[34]

[3]—Dispute Resolution Provisions

[a]—Generally

Beyond defining the specific terms and conditions of the lending relationship, effective loan documentation should also specify the procedures to be followed in resolving any disputes that arise between the parties. Thus, the procedures for using any specific form of desired alternative dispute resolution, such as arbitration, should be set forth. In the alternative, if normal court proceedings are to be permitted, lenders may consider including specific provisions for waiver of the right to a jury trial. Additional provisions should specify any limitations on the forum in which any suit may be filed and the law

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State Courts:

Maine: Diversified Foods Inc. v. The First National Bank of Boston, 605 A.2d 609,613 (Me. 1992) ("The Agreement provided that any modification must be in writing and contained an anti-waiver provision, stating that the Banks would not be deemed to have waived any default by inaction. Therefore, the course of dealing cannot have precluded the Banks from exercising its [sic] contractual rights.").

[34] See North, "Drafting Loan Documents to Minimize Lender Liability," Lender Liability: Theories and Practice 97, 112-113 (Pa. Bar Institute 1988).

which governs the substantive relationship of the parties. The potential use of each of these provisions is examined in detail below.

[b]—Arbitration

With the large jury verdicts which have repeatedly been returned against lenders across the country, arbitration has increasingly been examined by lenders as a form of alternative dispute resolution. Several financial institutions and governmental agencies have adopted arbitration as their preferred technique for resolving many commercial and consumer loan and supervisory disputes,[35] and the literature on arbitration of financial disputes is rapidly expanding.[36] Compulsory arbitration of lender liability claims should be enforceable most easily under the Federal Arbitration Act,[37] which applies to arbitration

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[35] Kaplinsky and Levin, "Alternative to Litigation Attracting Consumer Financial Services Companies," 1 Consumer Financial Services Law Report 1 (June 27, 1997); "Banks Force Griping Customers to Forego Courts for Arbitration," Wall Street Journal, at B-1 (Jan. 20, 1993); Butler, "Arbitration: Why Lenders Are Taking a New Look," 1 Lender Liability News, Part 2, at 11-12 (June 15, 1988).

[36] See, e.g.: Kaplinsky, Levin, and Bryce, "Arbitration Developments: Concepcion—The Supreme Court Decisively Steps In," 67 Bus. Law 629 (2012); Schwartz, "Claim-Suppressing Arbitration: The New Rules," 87 Ind. L.J. 239 (2012); Blechschmidt, "All Alone in Arbitration: AT&T Mobility v. Concepcion and the Substantive Impact of Class Action Waivers," 160 U. Pa. L. Rev. 541 (2012); Horton, "Arbitration as Delegation," 86 N.Y.U. L. Rev. 437 (May 2011); Sugumaran, "Arbitration—United States Supreme Court Sounds the Death Knell for Class Arbitration—Stolt-Nielsen S.A. v. Animalfeeds Int'l Corp., 130 S. Ct. 1758 (2010)," 16 Suffolk J. Trial & App. Advoc. 147 (2011); Sileo, "Arbitration Clause in Subprime Loan Contract Declared Unconscionable," 44 Trial 20 (May 2008); Cassling, "Arbitration Provisions Contained Only in Customer Agreement Amendments Sent after the Loan Was Made Held Unenforceable," 125 Banking L.J. 284 (March 2008); Cassling, "Arbitration Provision in Bank's Signature Card Is Procedurally and Substantively Unconscionable," 125 Banking L.J. 99 (Jan. 2008); Nelson, "Discover Bank v. Superior Court: The Unconscionability of Classwide Arbitration Waivers in California," 30 Am. J. Trial Advoc. 649 (Spring 2007); Reichner, "Third Circuit Orders Arbitration of Chapter 13 Borrower's Claims Against Lender," 60 Consumer Fin. L.Q. Rep. 29 (Spring 2006); Butler, *Arbitration in Banking: State of the Art* (1988).

[37] 9 U.S.C. §§ 1 *et seq*. See, e.g., KPMG LLP v. Cocchi, ___ U.S. ___, 132 S.Ct. 23, 181 L.Ed.2d 323 (2011) (FAA leaves no place for exercise of discretion by district courts, but instead mandates that district courts shall direct parties to proceed to arbitration on issues as to which arbitration agreement has been signed; thus, when complaint contains both arbitrable and nonarbitrable claims, FAA requires courts to compel arbitration of pendent arbitrable claims when party files motion to compel, even when result would be possibly inefficient maintenance of separate proceedings in different fora). See also, e.g., Geosurveys, Inc. v. State National Bank, 143 S.W.3d 220 (Tex. App. 2004) (plaintiff contended that the trial court erred in ordering the cause to arbitration under the Federal Arbitration Act because there was no issue of interstate commerce; however, the arbitration agreement stated that the rules of the American Arbitration Association would apply to any dispute and that the Federal

of any transaction involving interstate commerce,[38] and preempts contrary state laws that would preclude enforcement of a contractual

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Arbitration Act would apply to the construction, interpretation, and enforcement of the arbitration agreement; where the parties designate in the arbitration agreement which arbitration statute they wish to be controlling, the court should apply their choice).

Cf., Amato v. KPMG LLP, 433 F. Supp.2d 460 (M.D. Pa. 2006), *motion for reconsideration on other grounds granted* 2006 WL 2376245 (M.D. Pa. 2006) (generic choice-of-law clause, standing alone, is insufficient to support finding that contracting parties intended to opt out of FAA's default standards; rather, parties must expressly include state's arbitration rules in choice of law clause if they intend to contract out of FAA; in this case, because choice of law provision in customer agreement did not appear in arbitration provision of agreement, did not expressly incorporate New York's arbitration laws, and did not opt out of FAA, FAA governed).

[38] 9 U.S.C. § 2 (prior agreement to arbitrate must be part of a contract "evidencing a transaction involving [interstate] commerce").

See, e.g.:

Second Circuit: In re Currency Conversion Fee Antitrust Litigation, 265 F. Supp.2d 385 (S.D.N.Y. 2003) (when a contract contains a written arbitration clause and concerns a transaction involving commerce, the Federal Arbitration Act governs; court noted that there is a strong federal policy favoring arbitration as an alternative means of dispute resolution).

Eleventh Circuit: Blinco v. Green Tree Servicing, LLC, 366 F.3d 1249 (11th Cir. 2004) (as matter of first impression, court held that proceedings in district court should be stayed pending resolution of non-frivolous appeal from denial of motion to compel arbitration; court explained that section 16 of Federal Arbitration Act grants party right to file interlocutory appeal from denial of motion to compel arbitration, and, by providing such swift access to appellate review, Congress acknowledged that one of principal benefits of arbitration—avoiding high costs and time involved in judicial dispute resolution—would be lost if case were to proceed in both judicial and arbitral forums; court noted, however, that courts have split on issue).

State Courts:

Alabama: SouthTrust Bank v. Bowen, 959 So.2d 624 (Ala. 2006) (although borrower argued that mortgage and home equity loans did not involve interstate commerce, loans required numerous activities that crossed state lines, including bank's obtaining of flood certification and title policy from Florida corporation and obtaining of credit reports from Georgia corporation; also, in connection with all its loans and mortgages, bank was required to comply with numerous federal regulations and is regulated by Federal Deposit Insurance Corporation).

Florida: Buckeye Check Cashing, Inc. v. Cardegna, 824 So.2d 228 (Fla. Dist. App. 2002) (in class action alleging that lender made illegal usurious loans disguised as check cashing transactions in violation of various Florida statutes, federal law controlled issue of whether action was subject to arbitration because arbitration agreement expressly provided that "this arbitration Agreement is made pursuant to a transaction involving interstate commerce, and shall be governed by the Federal Arbitration Act).

Mississippi: MS Credit Center, Inc. v. Horton, 926 So.2d 167 (Miss. 2006) (in determining applicability of the Federal Arbitration Act, and whether its provisions require the parties in a particular case to arbitrate, courts undertake a two-prong inquiry: (1) whether the agreement to be arbitrated has a nexus to interstate commerce and whether the terms of the arbitration agreement require the parties to arbitrate the kind of dispute in question; and (2) whether any legal constraints external to the agreement, such as fraud, duress, or unconscionability, foreclose arbitration of

agreement to arbitrate particular future claims.[39] That Act makes agreements to arbitrate future controversies "valid, irrevocable, and

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the claims; because credit and lending agreements such as those at bar must comply with federal laws and regulations, including the federal Truth-in-Lending Act and the Federal Trade Commission "holder in due course" rule, which were created under Congress' Commerce Clause powers, the contracts in the instant dispute had a nexus to interstate commerce, but the parties seeking to compel arbitration waived their right to do so by their substantial and unreasonable delay in pursuing that right coupled with active participation in the litigation process).

But *cf.,* American General Finance, Inc. v. Morton, 291 Ga. 637, 732 S.E.2d 746 (2001) (despite arbitration clause of loan governed by FAA court held state procedural statute not preempted).

[39] *Supreme Court:* CompuCredit Corp. v. Greenwood, __ U.S. __, 132 S.Ct. 665, 181 L.Ed.2d 586 (2012) (because Act under which claims were brought was silent as to resolution via arbitration, FAA requires parties to honor the terms of their signed agreements); AT&T Mobility LLC v. Concepcion, ___ U.S. ___, 131 S.Ct. 1740, 179 L.Ed.2d 742 (2011) (FAA preempts state law that conditions the enforceability of arbitration agreements on the availability of classwide arbitration when the agreement is in a consumer contract of adhesion a dispute between the parties to which predictably involves a small amount of damages); Doctor's Associates, Inc. v. Casarotto, 517 U.S. 681, 116 S.Ct. 1652, 134 L.Ed.2d 902 (1996) (Montana statute requiring arbitration clauses to be "typed in underlined capital letters on the first page of the contract" held preempted by FAA); Allied-Bruce Terminix Cos., Inc. v. Dobson, 513 U.S. 265, 115 S.Ct. 834, 130 L.Ed.2d 753 (1995); Dean Witter Reynolds, Inc. v. Byrd, 470 U.S. 213, 105 S.Ct. 1238, 84 L.Ed.2d 158 (1985).

Second Circuit: David L. Threlkeld & Co., Inc. v. Metallgesellschaft Ltd. (London), 923 F.2d 245 (2d Cir. 1991) (holding FAA preempted a Vermont law that barred the enforcement of an arbitration provision unless both parties had signed a specific acknowledgement of arbitration, and the agreement to arbitrate was displayed prominently in the contract).

Third Circuit: Osterneck v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 841 F.2d 508 (3d Cir. 1988) (applying Pennsylvania law).

Ninth Circuit: Kilgore v. KeyBank, National Ass'n., 673 F.3d 947 (9th Cir. 2012) (a state statute that outright prohibited arbitration of claims for public injunctive relief was preempted by the FAA); Arriaga v. Cross Country Bank, 163 F. Supp.2d 1189 (S.D. Cal. 2001) (state legislatures may not attempt to limit the enforceability of arbitration agreements governed by the FAA) (applying California law).

Eleventh Circuit: Taylor v. First North American National Bank, 325 F. Supp.2d 1304 (M.D. Ala. 2004) (to the extent that Alabama law requires that an arbitration agreement be conspicuous or disclosed in a particular way, it is preempted by the FAA).

State Courts:

Oregon: Berger Farms v. First Interstate Bank of Oregon, N.A., 148 Ore. App. 33, 934 P.2d 64 (1997).

But see: Klussman v. Cross Country Bank, 134 Cal. App.4th 1283, 36 Cal. Rptr.3d 728 (Cal. App. 2005) (FAA did not preempt California law concerning class action waivers in arbitration agreements; under California law, when an agreement requiring arbitration of disputes but waiving the right to bring classwide arbitration is embedded in a consumer contract of adhesion in a setting in which disputes between the contracting parties generally involve small amounts of damages, and when it is alleged that the party with the superior bargaining power has carried out a scheme to deliberately cheat large numbers of consumers out of individually small sums of money, the waiver becomes in practice the exemption of the superior party from responsibility for its own fraud; under these circumstances, such waivers are

enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract,"[40] and will apply even to RICO and

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unconscionable under California law and should not be enforced); Bell v. Congress Mortgage Co., 24 Cal. App.4th 1675, 30 Cal. Rptr. 2d 205 (1994) (denying motion to compel arbitration and finding loan agreement with mandatory arbitration clause to be contract of adhesion; court found waiver of right to jury trial in adhesion contract must be "clear and informed," and that no such waiver occurred where borrowers were elderly and unsophisticated, and signed the agreements in blank, and the arbitration clause was not made conspicuous "by highlighting, bold type, or with an opportunity for specific acknowledgement by initialing").

[40] 9 U.S.C. § 2 (1982). See also:

Supreme Court: Nitro-Lift Technologies, L.L.C. v. Howard, 133 S. Ct. 500, 184 L. Ed. 2d 328 (2012) (provision's validity subject to initial court determination, thereafter, arbitrator decides whether covenants are valid) (employment non-compete).

Second Circuit: In re Currency Conversion Fee Antitrust Litigation, 265 F. Supp.2d 385, 400 (S.D.N.Y. 2003) ("In accord with the strong policy favoring arbitration, federal courts read arbitration clauses as broadly as possible, and 'any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration.' . . . Indeed, arbitration must be compelled 'unless it may be said with positive assurance that the arbitration clause is not susceptible of an interpretation that covers the asserted dispute.'").

Third Circuit: Harris v. Green Tree Financial Corp., 183 F.3d 173 (3d Cir. 1999) (holding arbitration clause that was not conspicuously disclosed in home improvement loan documents enforceable against multiple challenges, including lack of mutuality and unconscionability).

Fifth Circuit: Green Tree Servicing, LLC v. Stephens, 2008 WL 1925174 (S.D. Miss. 2008) (FAA expresses strong national policy favoring arbitration of disputes, and all doubts concerning arbitrability of claims should be resolved in favor of arbitration; courts perform two-step inquiry to determine whether parties should be compelled to arbitrate a dispute: (1) court must first determine whether parties agreed to arbitrate dispute in question; and (2) court must determine if any legal constraints external to parties' agreement foreclose arbitration of claims).

Ninth Circuit: Arriaga v. Cross Country Bank, 163 F. Supp.2d 1189 (S.D. Cal. 2001) (statutory claims may be subject to arbitration unless Congress itself has evinced an intention to preclude a waiver of judicial remedies for the statutory rights at issue; such an intention of Congress can be found in three ways: (1) by looking to the text of the statute, (2) by looking to the legislative history, or (3) by finding an "inherent conflict" between arbitration and the statute's underlying purposes).

State Courts:

California: Brown v. Wells Fargo Bank, NA, 168 Cal. App.4th 938, 85 Cal. Rotr.3d 817 (2008) (applicable contract defenses, such as fraud, duress, or unconscionability, may be applied to invalidate arbitration agreements without contravening the Federal Arbitration Act, but courts may not invalidate arbitration agreements under state laws applicable *only* to arbitration provisions because by enacting section 2 of the FAA, Congress precluded the states from singling out arbitration provisions for suspect status, requiring instead that such provisions be placed "upon the same footing as other contracts").

Georgia: Cash In Advance of Florida, Inc. v. Jolley, 272 Ga. App. 282, 612 S.E.2d 101 (Ga. App. 2005) (plaintiff argued that arbitration agreement with lender was unenforceable because provision against recovery of attorneys' fees was illegal attempt to limit remedies for her claim under federal Truth In Lending Act; court held, however, that arbitration agreement was ambiguous as to available remedies (since the agreement also incorporated by reference AAA rules under which the arbitrator could grant

Federal securities law claims.[41] The Act gives the proponent of arbitration the right to petition for an order compelling arbitration in "any United States district court which, save for [the arbitration] agreement, would have jurisdiction under title 28, in a civil action or in admiralty of the subject matter of a suit arising out of the controversy between the parties."[41.1] The Supreme Court has interpreted this section of the Act as recognizing a federal court's jurisdiction over a petition to compel arbitration only when the underlying action is one that could be maintained in a federal court.[42]

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any remedy that a party could have received in court), requiring resolution in first instance by the arbitrator).

Mississippi: McKenzie Check Advance of Mississippi v. Hardy, 866 So.2d 446 (Miss. 2004) (because transactions involved interstate commerce and parties agreed their arbitration agreement would be governed by the FAA, trial court erred by failing to apply FAA to the arbitration agreement).

Texas: Geosurveys, Inc. v. State National Bank, 143 S.W.3d 220 (Tex. App. 2004) (because public policy favors arbitration, the Federal Arbitration Act imposes a strong presumption against waiver of the right to arbitration; thus, courts will not find that a party has waived its right to enforce an arbitration clause by merely taking part in litigation unless it has substantially invoked the judicial process to its opponent's detriment; in this case, that the defendant bank responded to plaintiff's lawsuit by making requests for interrogatories and a request for production of documents did not result in waiver its right to arbitration).

[41] *Supreme Court:* Green Tree Financial Corp.-Alabama v. Randolph, 531 U.S. 79, 121 S.Ct. 513, 148 L.Ed.2d 373 (2000); Rodriguez de Quijas v. Shearson/American Express, Inc., 490 U.S. 477, 109 S.Ct. 1917, 104 L. Ed.2d 526 (1989); Shearson/American Express, Inc. v. McMahon, 482 U.S. 220, 107 S.Ct. 2332, 96 L.Ed.2d 185 (1987).

Second Circuit: Kerr-McGee Refining Corp. v. M/T Triumph, 924 F.2d 467 (2d Cir. 1991) (reinstating treble damage award by arbitrators under RICO, and holding that arbitrators may properly consider evidence of defendant's misconduct directed at other parties under RICO's pattern of racketeering requirement); Development Bank v. Chemtex Fibers, Inc., 617 F. Supp. 55 (S.D.N.Y. 1985).

Third Circuit: Harris v. Green Tree Financial Corp., 183 F. 3d 173 (3d Cir. 1999) (holding arbitration clause which was not conspicuously disclosed in loan documents on a home improvement loan enforceable against multiple challenges, including lack of mutuality and unconscionability); Metcalf v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 768 F. Supp.2d 762 (M.D. Pa. 2011) (RICO action brought by filmmakers against companies that agreed to provide financing for film; arbitration clause in financing agreement held valid).

Fourth Circuit: Snowden v. Checkpoint Check Cashing, 290 F.3d 631 (4th Cir. 2002) (district court erred in denying motion to compel arbitration with regard to plaintiff's claims alleging violation of RICO (and of the Truth in Lending Act and the Maryland Consumer Protection Act, as well as fraud under Maryland common law)).

Eleventh Circuit: Robbins v. Paine Webber, Inc., 761 F. Supp. 773 (N.D. Ala. 1991) (vacating arbitration award for failure to award plaintiffs treble damages and attorneys' fees under RICO despite finding of fraud), *rev'd* 954 F.2d 679 (11th Cir. 1992).

[41.1] 9 U.S.C. § 4.

[42] Vaden v. Discover Bank, 556 U.S. 49, 129 S.Ct. 1262, 173 L.Ed.2d 206 (2009) (instruction of § 4 of FAA to district courts asked to compel arbitration to inquire whether court would have jurisdiction, "save for [the arbitration] agreement," over "a

Despite the broad language of the Act, there is authority that an arbitration clause may not be enforced where it contains provisions that defeat the remedial purpose of a statute.[43] Additional exceptions to the enforcement of arbitration clauses that have been recognized by some courts are that such clauses may not be enforced when their terms are grossly favorable to a lender that has overwhelming bargaining power,[44] and that arbitration clauses are enforceable only in the sound discretion of the bankruptcy judge when the debtor in a

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suit arising out of the controversy between the parties" must be read in light of well-pleaded complaint rule and corollary rule that federal jurisdiction cannot be invoked on basis of a defense or counterclaim; parties may not circumvent these rules by asking federal court to order arbitration of portion of controversy that implicates federal law when court would not have federal question jurisdiction over controversy as a whole; it does not suffice to show that federal question lurks somewhere inside parties' controversy, or that defense or counterclaim would arise under federal law).

[43] Green Tree Financial Corp-Alabama. v. Randolph, 531 U.S. 79, 121 S.Ct. 513, 148 L.Ed.2d 373 (2000) (recognizing the principle but finding its applicability in the case at bar had not been established).

See also, e.g., Mortgage Electronic Registration Systems, Inc. v. Abner, 260 S.W.3d 351 (Ky. App. 2008) (arbitration provision was unconscionable and unenforceable because it clearly prevented plaintiffs from meaningfully pursuing their statutory claims).

Cf. Cash In Advance of Florida, Inc. v. Jolley, 272 Ga. App. 282, 612 S.E.2d 101 (Ga. App. 2005) (enforcing arbitration agreement notwithstanding borrower's claim that it deprived her of a remedy guaranteed by the Truth in Lending Act because the court found the agreement ambiguous on that issue, but noting that after the completion of the arbitration she could "seek judicial review of the arbitrator's award if she feels her rights were compromised").

But see, Johnson v. West Suburban Bank, 225 F.3d 366 (3d Cir. 2000) (arbitration clause can be enforced in consumer lending context to bar consumer's ability to pursue a class action).

[44] See:

Alabama: Anderson v. Ashby, 873 So.2d 168 (Ala. May 16, 2003) (arbitration agreement included in note and security agreement was unconscionable and therefore unenforceable; terms were grossly favorable to lender, and lender had overwhelming bargaining power in obtaining arbitration agreement, while borrowers had no input into negotiating terms of or drafting arbitration agreement, and borrowers had no meaningful choice in accepting agreement).

California: Klussman v. Cross Country Bank, 134 Cal. App.4th 1283, 36 Cal. Rptr.3d 728 (Cal. App. 2005).

Illinois: Tortoriello v. Gerald Nissan of North Aurora, Inc., 379 Ill. App.3d 214, 317 Ill. Dec. 583, 882 N.E.2d 157 (Ill. App. 2008) (arbitration provision was not procedurally unconscionable when, although clause was not conspicuous, it was brought to consumer's attention by other provisions in contract of which clause was part; nor was provision substantively unconscionable, because disparity of bargaining power was typical of contracts of adhesion and contracts of adhesion are not per se unconscionable).

Oregon: Vasquez-Lopez v. Beneficial Oregon, Inc., 210 Or. App. 553, 152 P.3d 940 (Ore. App. 2007) (arbitration rider to loan agreement held unconscionable and thus unenforceable because of disparity in bargaining power and misrepresentation as to contents of agreement).

bankruptcy proceeding sues on a contract that calls for arbitration and the defendant demands a stay of the bankruptcy proceeding pending the arbitration.[45] A right to arbitration may also be waived by a party's actions if those actions have prejudiced the opposing party.[46] In addition, under the law of at least some states the question whether grounds exist at law or in equity for the revocation of an arbitration agreement is for a court, rather than an arbitrator, to decide.[46.1]

The United States Supreme Court has held that an attack on a contract as void for illegality because it contained a usurious finance charge was to be determined by an arbitrator, not a court, because the claim challenged the contract as whole, not the arbitration provision

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[45] Zimmerman v. Continental Airlines, Inc., 712 F.2d 55 (3d Cir. 1983), *cert. denied* 464 U.S. 1038 (1984). But see, Hays and Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 885 F.2d 1149 (3d Cir. 1989) (bankruptcy courts have only limited discretion to deny enforcement of a contractual arbitration clause in noncore matters—see Broude, *Reorganizations Under Chapter 11 of the Bankruptcy Code* § 2.04[3] (Law Journal Press 1986) for a discussion of core and noncore matters). It should also be noted that *Zimmerman* relied on Wilko v. Swan, 346 U.S. 427, 74 S.Ct. 182, 98 L.Ed. 168 (1953), which was overruled by Rodriguez de Quijas v. Shearson/American Express, Inc., 490 U.S. 477, 109 S.Ct. 1917, 104 L.Ed.2d 526 (1989).

[46] See, e.g.:

Fifth Circuit: Hafer v. Vanderbilt Mortgage and Finance, Inc., 793 F. Supp.2d 987 (S.D. Tex. 2011) (waiver will be found when party seeking arbitration substantially invokes judicial process to detriment or prejudice of other party; waiver occurs when party seeking arbitration engages in some overt act in court that evinces desire to resolve arbitrable dispute through litigation rather than arbitration; however, waiver of arbitration is not favored finding and there is presumption against it; since claims litigated by defendants in other suits were distinct from claims to be litigated in the case at bar because plaintiffs were different, as were contracts giving rise to plaintiffs' claims, there was no waiver).

Eleventh Circuit: Gipson v. Cross Country Bank, 354 F. Supp.2d 1278 (M.D. Ala. 2005) (a party may waive the right to arbitrate by its conduct, such as invoking "litigation machinery" prior to seeking arbitration and acting inconsistently with a right to arbitrate; in this case, however, plaintiff's participation in litigation was not inconsistent with an intent to arbitrate, but rather evidenced an intent to ensure that she would be able to effectively vindicate her statutory rights whether in court or in arbitration). See also, discussion at § 4.04[5] *infra*.

State Courts:

Georgia: USA Payday Cash Advance Center # 1, Inc. v. Evans, 281 Ga. App. 847, 637 S.E.2d 418 (Ga. App. Aug. 24, 2006) (party waives right to arbitrate if, under totality of circumstances, party has acted inconsistently with arbitration right, and in so acting, has in some way prejudiced other party; in this case, trial court properly concluded that defendants waived right to arbitration by engaging in actions inconsistent with right to arbitration, including moving to compel arbitration more than a year after the filing of complaint, extending time within which to respond and responding to discovery, opposing plaintiffs' motion to amend on merits, and filing leaves of absences and motions for *pro hac* vice admissions).

[46.1] See: Discover Bank v. Superior Court of Los Angeles, 36 Cal.4th 148, 30 Cal. Rptr.3d 76 (Cal. 2005); *Klussman v. Cross Country Bank*, N. 44 *supra*.

of the contract in particular.[46.2] This conclusion derived from three propositions previously established by the Court: (1) as a matter of substantive federal arbitration law, an arbitration provision is severable from the remainder of the contract; (2) unless the challenge is to the arbitration clause itself, the issue of the contract's validity is considered by the arbitrator in the first instance; and (3) this arbitration law applies in state as well as federal courts.[46.3] The Court was careful to distinguish a claim of a contract's validity from a claim that the agreement was never entered into, and addressed only the former type of claim. Thus, it has been held that when the very existence of a contract containing the relevant arbitration agreement is called into question, the federal courts have authority and responsibility to decide the matter. This is because if it is ultimately found no valid agreement existed, then no agreement to arbitrate was ever concluded. The

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[46.2] Buckeye Check Cashing, Inc. v. Cardegna, 546 U.S. 440, 126 S.Ct. 1204, 163 L.Ed.2d 1038 (2006). See also Rent-A-Center, West, Inc. v. Jackson, ___ U.S. ___, 130 S.Ct. 2772, 177 L.Ed.2d 403 (2010) (provision of employment agreement that delegated to an arbitrator exclusive authority to resolve any dispute relating to the agreement's enforceability as a whole was a valid delegation under the Federal Arbitration Act).

Compare:

Third Circuit: Puleo v. Chase Bank USA, N.A., 605 F.3d 172 (3d Cir. 2010) (contention that class action waiver in arbitration agreement between credit card holders and issuing bank was unconscionable, and thus unenforceable, challenged validity of arbitration provision within a larger agreement, apart from the validity of the contract as a whole, and thus under Federal Arbitration Act the enforceability of the arbitration provision was question for court to decide).

State Courts:

Kentucky: Mortgage Electronic Registration Systems, Inc. v. Abner, 260 S.W.3d 351, 353 (Ky. App. 2008) (court, not arbitrator, must decide whether parties have agreed to arbitrate based on fundamental principles governing contract law because "Appellees are not simply claiming that the . . . contract as a whole is unconscionable, but rather that the arbitration clause *itself* is unconscionable and unenforceable) (emphasis in original)).

Oregon: Vasquez-Lopez v. Beneficial Oregon, Inc., 210 Or. App. 553, 152 P.3d 940 (Ore. App. 2007) (holding that it is for the *court* to determine whether the arbitration provision in a contract is enforceable if the party opposing arbitration puts that particular provision at issue—in the case at bar, on the ground of unconscionability—even though the complaint in the case and the legal theories underlying it did not implicate the arbitration provision, and concluding that the Court in *Buckeye*, *supra*, "implied that, if the challenge to the arbitration clause[] had been distinct, the trial court could have decided arbitrability itself").

[46.3] See: Southland Corp. v. Keating, 465 U.S. 1, 104 S.Ct. 852, 79 L.Ed.2d 1 (1984) (challenging agreement to arbitrate as void under California law insofar as it purported to cover claims brought under the state Franchise Investment Law); Prima Paint Corp. v. Flood & Conklin Manufacturing Co., 388 U.S. 395, 87 S.Ct. 1801, 18 L.Ed.2d 1270 (1967) (if the claim is fraud in the inducement of the arbitration clause itself—an issue going to the making of the agreement to arbitrate—the federal court may proceed to adjudicate it; however, a federal court may not consider claims of fraud in the inducement of the contract generally).

arbitrator consequently would have no authority to decide anything.[46.4]

Arbitration has both strengths and weaknesses as a form of dispute resolution. Each lender should therefore carefully evaluate both sides of the arbitration question before choosing to implement a mandatory system of arbitration of disputes arising out of a lending relationship. Three major strengths are commonly claimed[47] for arbitration:

(1) Arbitration discourages unreasonable awards. While this is probably true generally, there is little real experience to date in the arbitration of commercial lending disputes.[48] Several such arbitrations have resulted in multimillion-dollar awards against lenders.[49]

[46.4] Will-Drill Resources, Inc. v. Samson Resources Co., 352 F.3d 211 (5th Cir. 2003) (only if arbitration clause is attacked on independent basis, such as on ground that signature was forged or that agent lacked authority to bind principal, can court decide the dispute; general attacks on agreement are for arbitrator).

See also, e.g., Hafer v. Vanderbilt Mortgage and Finance, Inc., 793 F. Supp.2d 987 (S.D. Tex. 2011) (noting exception for independent attacks on agreement but holding that in the case at bar plaintiffs did not question existence of agreements they signed, and thus plaintiffs' claim that their debts under agreements were released was appropriate for submission to arbitrator).

[47] See, e.g., Butler, "Arbitration: Why Lenders Are Taking a New Look," 1 Lender Liability News, Part 2, at 12 (June 15, 1988).

[48] One commentator reports that the American Arbitration Association had only eighty financial arbitrations as of Spring 1988. Butler, "Arbitration: Advantages, Concerns for Lenders," 1 Lender Liability News, Part 2, at 10 (July 13, 1988).

[49] See: "Damages to Firm in Loan Dispute," The American Banker, at 2 (Jan. 4, 1988) (reporting on $3,200,000 award to Seis-Port Exploration, Inc. against Capitol Federal Savings & Loan Association by the Judicial Arbiter Group of Boulder, Colorado); "Lender, as Joint Venture Partner, Loses California Arbitration and Suffers Judgment of $2.9 Million," 3 Lender Liability Law Report, at 4 (May 1990) (reporting on $2,900,000 award against Saratoga Savings and Loan Association for breach of a joint venture agreement and breach of fiduciary duty). An appeal from the arbitration award was denied. Saratoga Savings and Loan Association v. Tate, 216 Cal. App. 3d 843, 265 Cal. Rptr. 440 (1989). See also: Kerr-McGee Refining Corp. v. M/T Triumph, 924 F.2d 467 (2d Cir. 1991) (upholding $512,520.10 treble damage arbitration award under RICO in shipping charter case); "Lawrence Savings Bank," Wall Street Journal, at A-5 (May 19, 1993) (reporting on $12 million arbitration award in favor of lender in case involving default on $13 million in commercial loans); "Arbitration in FDIC Case Against Accountants Yields Small Recovery," Wall Street Journal, at B-10 (Mar. 8, 1991) (reporting on $2,500,000 arbitration award on professional liability claim of $46 million brought by FDIC against accounting firm for failed bank); "Arbitrator awards consumers $20 million for lender's 'shocking' breach of law," 4 Consumer Financial Services Law Report, at 1 (Aug. 18, 2000) (reporting upon arbitration award of $26,883,170 against lender that failed properly to advise its borrowers of their state law rights to select their own attorney and insurance agent).

A study of arbitration in securities cases showed that between May 1989 and January 1990, 532 of 964 arbitrated cases were won by investors, with the average award for 43% of the damages sought. See Clareman, "The New Rules of Suing a

(2) Arbitration is speedier and less expensive than traditional litigation, because of the elimination of motion practice and discovery and the existence of limited appeal rights.[49.1] Empirical evidence suggests that this is not true for large commercial cases, since more arbitrated cases of this type go to final judgment than do litigated cases in the courts, thereby taking just as much time to finally resolve the

(Text continued on page 1-41)

Broker," Fortune, at 207, 208 (Fall 1990). A survey of 2,279 customer-initiated securities cases before self-regulatory organizations between May 1989 and August 1990 similarly reported that customers won 58.1% of the cases, recovering about 40% of the damages sought. See DeBenedictis, "Arbitration Fair to Stock Buyers," American Bar Association Journal, at 25 (Feb. 1992). See also: Siconolfi, "Paine Webber Ordered to Pay $2.3 Million," Wall Street Journal," at A-5C (Sept. 18, 1992) (reporting on arbitration award of $2.3 million, including $1.6 million in punitive damages, against brokerage firm for unauthorized purchases); "Cigna is Ordered to Pay $5.3 Million for Selling Risky Investments to Retiree," Wall Street Journal, at A-3 (March 12, 1992) (reporting on $3.5 million punitive damages award for selling retiree unsuitable investments in twelve risky limited partnerships which lost 90% of their value); "Dean Witter was ordered to pay $788,000 in dispute with investor," Wall Street Journal, at B-7 (May 9, 1991) (reporting on $500,000 punitive damages award against broker on churning claim).

49.1 See AT&T Mobility LLC v. Concepcion, ___ U.S. ___, ___, 131 S. Ct. 1740, 1749, 179 L.Ed.2d 742 (2011) ("The point of affording parties discretion in designing arbitration processes is to allow for efficient, streamlined procedures tailored to the type of dispute. It can be specified, for example, that the decisionmaker be a specialist in the relevant field, or that proceedings be kept confidential to protect trade secrets. And the informality of arbitral proceedings is itself desirable, reducing the cost and increasing the speed of dispute resolution.").

matter.[50] Moreover, lack of cooperation in the arbitration process may lead to proceedings even lengthier than traditional litigation.[51] Arbitration of a dispute is often concluded within six to twelve months, however, with only one or two days of actual hearings.[52] Nevertheless, lenders may wish to preserve some discovery rights, and arbitration agreements can be crafted to permit limited discovery for both sides.[53]

(3) Arbitration preserves privacy because of the lack of public access to the hearings and the absence of a written opinion explaining any award.

Arbitration also has notable weaknesses which must be assessed by lenders. These include:

(1) Arbitrators tend to compromise disputes.[54]

(2) Rights to appeal are extremely limited. Under the Federal Arbitration Act, for example, no appeal is permitted except for fraud in procuring the award, partiality or corruption by the arbitrators, gross misconduct by the arbitrators, or failure to render a final decision.[55]

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[50] See Hayes and Hagedorn, "Arbitration in Commercial Cases Found to Save Money, Not Time," Wall Street Journal, at B-10 (Sept. 5, 1990) (reporting results of four-year study by Rand Corporation's Institute for Civil Justice of cases arbitrated in the United States District Court for the Middle District of North Carolina).

[51] See, e.g., Feinstein, "Eight-Year Arbitration Dispute Shows How Process Can Be Messy," Wall Street Journal, at B-9 (Nov. 21, 1988).

[52] Butler, "Arbitration: Why Lenders Are Taking a New Look," 1 Lender Liability News, Part 2, at 12 (June 15, 1988).

[53] Butler, *Arbitration in Banking: State of the Art* 33-34 (1988).

[54] But see, "Not Necessarily Solomonic," Wall Street Journal, at B-2 (Sept. 27, 1993) (reporting on study by American Arbitration Association of 4,223 commercial arbitrations completed in 1992 which concluded that arbitrators decided only one in ten cases in an award midway between the parties' positions, and rejected plaintiffs' claims completely in nearly one-third of the cases).

[55] 9 U.S.C. § 10. See also:

California: Saratoga Savings and Loan Association v. Tate, 216 Cal. App.3d 843, 265 Cal. Rptr. 440 (Cal. App. 1989).

South Carolina: Bazzle v. Green Tree Financial Corp., 351 S.C. 244, 569 S.E.2d 349 (S.C. 2002), *vacated on other grounds* 539 U.S. 444, 123 S.Ct. 2402, 156 L.Ed.2d 414 (2003) (the FAA provides extremely limited grounds for vacating an arbitrator's award, i.e., when: (1) the award was procured by corruption, fraud, or undue means; (2) there was evident partiality or corruption in the arbitrators; (3) the arbitrators were guilty of misconduct in refusing to postpone a hearing, or in refusing to hear pertinent evidence, or any other misconduct by which parties' rights have been prejudiced; or (4) the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made; if an arbitrator acted even *arguably* within the scope of his authority, even a *serious* error on his part does not warrant overturning his decision).

(3) Many courts have ruled that unless prohibited by a specific arbitration clause,[55.1] arbitrators can award punitive damages,[56] and arbitrators are starting to do so more often.[57]

(4) Unless carefully retained in an appropriate arbitration clause, lenders may lose their rights to self-help relief or resort to the courts for injunctive and provisional relief.[58]

Given these affirmative and negative aspects of arbitration, and particularly in light of the lack of extensive experience with this technique

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[55.1] See, e.g., Green Tree Servicing, LLC v. Stephens, 2008 WL 1925174 (S.D. Miss. 2008) (noting that federal courts have held that provisions in arbitration agreements prohibiting punitive damages are generally enforceable [citing Mastrobuono v. Shearson Lehman Hutton, Inc., 514 U.S. 52, 56-57, 115 S.Ct. 1212, 131 L.Ed.2d 76 (1995), N. 56 *infra*).

[56] *Supreme Court:* Mastrobuono v. Shearson Lehman Hutton, Inc., 514 U.S. 52, 115 S.Ct. 1212, 131 L.Ed.2d 76 (1995) (choice of law provision in arbitration agreement stating that agreement shall be governed by New York law does not preclude an award of punitive damages where agreement provides for arbitration of any controversy between the parties in accordance with the rules of the National Association of Securities Dealers or the New York or American Stock Exchanges, since choice of law provision is, at most, ambiguous, and ambiguities as to the scope of an arbitration clause under the FAA must be resolved in favor of arbitration).

First Circuit: Raytheon Co. v. Automated Business Systems, Inc., 882 F.2d 6 (1st Cir. 1989).

Fourth Circuit: Willis v. Shearson/American Express Inc., 569 F. Supp. 821 (M.D.N.C. 1983).

Eleventh Circuit: Bonar v. Dean Witter Reynolds, Inc., 835 F.2d 1378 (11th Cir. 1988). See also In re Managed Care Litigation, 132 F. Supp.2d 989 (S.D. Fla. 2000) (arbitration clause prohibiting award of punitive damages held not enforceable with regard to RICO claims as enforcement would prevent relief that would otherwise have been available under statute).

State Courts:

Alabama: Willoughby Roofing & Supply Co. v. Kajima International, Inc. 598 F. Supp. 353 (N.D. Ala. 1984), *aff'd memo,* 776 F.2d 269 (11th Cir. 1985) (applying Alabama law).

California: Saratoga Savings and Loan Association v. Tate, 216 Cal. App. 3d 843, 265 Cal. Rptr. 440 (1989); Baker & Sadick, 162 Cal. App.3d 618, 208 Cal. Rptr. 676 (1984).

Rhode Island: McBurney v. The GM Card, 869 A.2d 586 (R.I. 2005).

Contra:

New York: Garrity v. Lyle Stuart, Inc., 40 N.Y. 2d 354, 386 N.Y.S.2d 831, 353 N.E.2d 793 (1976).

[57] See: Siconolfi, "Paine Webber Ordered to Pay $2.3 Million," Wall Street Journal, at A-5C (Sept. 18, 1992) (reporting on arbitration award against brokerage firm of $2.3 million, including $1.6 million in punitive damages, for making unauthorized purchases); Siconolfi, "Stock Investors Win More Punitive Awards In Arbitration Cases," Wall Street Journal, at A-1 (June 11, 1990) (reporting twenty-one punitive damages awards totaling $4,500,000 to investors between May of 1989 and June of 1990).

[58] Butler, "Arbitration Advantages, Concerns for Lenders," 1 Lender Liability News, Part 2, at 10 (July 13, 1988).

in the lender liability context, financial institutions should be careful in requiring arbitration on a large scale basis. Perhaps the best approach today is to select some test cases on troubled loans for which both sides agree to arbitration. Another approach is to require arbitration in some loan restructurings when amended loan documentation must be prepared, and arbitration of any disputes which arise thereafter may be required in consideration of monetary concessions by the lender.

When lenders do choose to require compulsory arbitration of lender liability claims, the following drafting issues must be addressed in the arbitration clause:

(1) The number of arbitrators. Some commentators recommend an increasing number depending upon the amount claimed.[59] A better and safer course to avoid both runaway and compromise awards is to require three arbitrators in all cases.

(2) The arbitrators' qualifications. The arbitration clause should require selection of arbitrators with knowledge of financial and banking practices.[60] Some lenders require the appointment of attorneys or judges as the presiding referee.[61]

(3) The selection process for arbitrators. One acceptable approach is for each side to select one arbitrator, with the two arbitrators thus selected choosing the third arbitrator.

(4) Whether any limited rights of discovery should be provided.

(5) Whether any expanded right of appeal or power to entertain pre-trial motions should be permitted. These, however, seem contrary to the basic purposes sought to be served by requiring arbitration.

(6) The scope of the arbitrable issues. If arbitration is to be effective in lender liability claims, it should extend to all disputes, including tort claims, arising directly or indirectly under the loan documentation or from the lending relationship.[62]

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[59] Butler, "'Model' Arbitration Clause for Financial Institutions," 1 Lender Liability News, Part 2, at 11-12, ¶ (d) (Aug. 10, 1988) (hereinafter cited as "Butler, Model Arbitration Clause").

[60] See *id*. See also, e.g., AT&T Mobility LLC v. Concepcion, ___ U.S. ___, ___, 131 S.Ct. 1740, 1749, 179 L.Ed.2d 742 (2011) (noting that one of the advantages of arbitration is that "[i]t can be specified, for example, that the decisionmaker be a specialist in the relevant field, or that proceedings be kept confidential to protect trade secrets").

[61] Butler, "Arbitration Clauses for Financial Institutions," 1 Lender Liability News, Part 2, at 11 (Sept. 21, 1988).

[62] See Butler, Model Arbitration Clause, N. 59 *supra,* at 11, ¶ (a). See also:

Supreme Court: Green Tree Financial Corp. v. Bazzle, 539 U.S. 444, 123 S.Ct. 2402, 156 L.Ed.2d 414 (2003) (whether arbitration contracts permitted or forbade class arbitration was issue for arbitrator).

Second Circuit: Kerr-McGee Refining Corp. v. M/T Triumph, 924 F.2d 467 (2d Cir. 1991) (holding that arbitrators could properly consider actions directed at third parties to establish a RICO pattern of racketeering activity under a shipping charter requiring arbitration of all disputes "arising out of this charter").

(7) Whether the arbitrators should expressly be permitted to award punitive damages, or should expressly be barred from doing so.[63]

(8) The availability of provisional remedies. These should be expressly preserved,[64] although such a provision might be interpreted as waiving rights to arbitrate a dispute.

(9) The law under which the scope and enforceability of the arbitration is to be determined. Here, the Federal Arbitration Act is broadest, and should be specified.[65]

(10) The power of the arbitrators to award the prevailing party attorneys' fees and other costs.[66] This seems unwise, since it will either encourage compromise awards or be ignored, if only permissive.

(11) The manner of negotiation of the arbitration clause. The better practice is to require execution of a separate document or to include the arbitration provision in boldface right above the signature lines in the loan agreement.[67]

(12) The power of the arbitrators to decide the arbitrability of the dispute.[68]

Compare:

Alabama: CitiFinancial Corp., L.L.C. v. Peoples, 2007 WL 1454441 (Ala. 2007) (claim by borrower alleging wrongful foreclosure on mortgage loan was arbitrable, and lender did not waive right to arbitrate by invoking litigation process when it instituted foreclosure and eviction proceedings, because arbitration provision specifically excluded from arbitration "[a]ny action to effect a foreclosure to transfer title to the property being foreclosed"); Liberty Finance Inc. v. Carson, No. 1990400, 2000 Ala. LEXIS 333 (Ala. Aug. 4, 2000) (arbitration clause ruled not to apply to dispute regarding required purchase of credit life insurance and credit disability insurance on loan, where arbitration clause covered "[a]ny dispute, controversy or claim arising out of or relating to any benefits or coverage hereunder or the breach thereof").

Oregon: Berger Farms v. First Interstate Bank of Oregon, N.A., 148 Ore. App. 33, 939 P.2d 64 (Ore. App. 1997) (holding that claims of breach of fiduciary duty and negligent misrepresentation based on existing lender's promise to provide construction financing for a new plant fell outside the scope of arbitration agreements contained in the loan documentation for an existing loan).

See also, Gipson v. Cross Country Bank, 354 F. Supp.2d 1278 (M.D. Ala. 2005) (when an arbitration provision does not expressly permit or prohibit class-wide arbitration, the decision as to whether the contract forbids class arbitration is for the arbitrator, not the court; however, when a contract expressly prohibits class arbitration, there is no issue of contract interpretation for an arbitrator to determine).

[63] See cases cited in N. 56 *supra*.

[64] For a form of provision to preserve such remedies, see Butler, Model Arbitration Clause, N. 59 *supra,* at 11, ¶ (c).

[65] See *id*. at 11, ¶ (a).

[66] See *id*. at 12, ¶ (e).

[67] See discussion at Ns. 71-89 *infra* regarding the enforceability of jury waiver clauses and the incorporation of other safeguards to maximize the likelihood that such provisions will be enforced.

[68] See First Options of Chicago Inc. v. Kaplan, 514 U.S. 938, 115 S.Ct. 1920, 131 L.Ed.2d 985 (1995). See also, e.g., CitiFinancial Corp., L.L.C. v. Peoples, 2007 WL

(13) The agreement of the parties that judgment shall be entered on the arbitration award in a specific federal court.[69]

(14) Whether or not the agreement should preclude class actions.[69.1]

1454441 (Ala. 2007) (question presented was whether arbitration provision clearly and unmistakably provided that arbitrator should decide arbitrability; court concluded that incorporation into arbitration provision of Commercial Rules of American Arbitration Association, conferring authority to decide such issues on arbitrator, evidenced such an intent).

[69] See PVI Inc. v. Ratiopharm GmbH, 135 F.3d 1252 (8th Cir. 1998). See generally, Koopersmith and Johnson, "Murky Language Dooms Arbitration," *New York Law Journal*, Sept. 21, 1998, at S5, col. 1.

[69.1] See generally, AT&T Mobility LLC v. Concepcion, ___ U.S. ___, 131 S.Ct. 1740, 179 L.Ed.2d 742 (2011) (California decision holding class action waivers unconscionable when found in consumer contracts of adhesion disputes between the parties to which predictably involve a small amount of damages held preempted and thus invalid under FAA, which generally favors arbitration and terms of parties' agreements to arbitrate); Stolt-Nielsen S.A. v. AnimalFeeds International Corp., ___ U.S. ___, 130 S.Ct. 1758, 176 L.Ed.2d 605 (2010) (if the parties had reached no agreement as to whether class arbitration could be had, the parties could not be compelled to submit to class arbitration because arbitration is a matter of consent).

See also, e.g.:

Illinois: Keefe v. Allied Home Mortgage Corp., 393 Ill. App.3d 226, 332 Ill. Dec. 124, 912 N.E.2d 310 (2009) (although class-action waivers are not *per se* unconscionable, under the particular facts and circumstances of the case at bar a prohibition on the class treatment of small consumer claims was substantively unconscionable because individual arbitration claims would be cost-prohibitive).

New York: Hayes v. County Bank, 26 A.D.3d 465, 811 N.Y.S.2d 741 (N.Y. App. Div. 2006) (fact that arbitration agreements effectively precluded plaintiff from pursuing class action did not alone render them substantively unconscionable).

North Carolina: Tillman v. Commercial Credit Loans, Inc., 2006 WL 1526826 (N.C. App. 2006) (class action waiver in arbitration agreement does not, in and of itself, render arbitration agreements unenforceable).

But *cf.*:

California: Discover Bank v. Superior Court, 36 Cal.4th 148, 30 Cal. Rptr.3d 76, 113 P.3d 1100 (2005) (arbitration agreement is not *per se* unconscionable because it prohibits class-wide arbitration, but when waiver is found in consumer contract of adhesion in setting in which disputes between contracting parties predictably involve small amounts of damages, and when it is alleged that party with the superior bargaining power carried out scheme to deliberately cheat large numbers of consumers out of individually small sums of money, waiver is unconscionable under California law and should not be enforced); Paton v. Cingular Wireless, 2006 WL 1413537 (Cal. App. 2006) (*accord*).

New Jersey: Muhammad v. County Bank of Rehoboth Beach, Delaware, 2006 WL 2273448 (N.J. Aug. 9, 2006) (class arbitration waiver in payday loan contract of adhesion was unconscionable due to public interest at stake, as class-arbitration bar effectively prevented borrower from pursuing her consumer protection rights and shielded lenders from compliance with state law; individual consumer fraud case involved small amount of damages, rendering individual enforcement of plaintiff's rights, and rights of her fellow consumers, difficult if not impossible; in such circumstances class-action waiver acted effectively as exculpatory clause).

[c]—Waiver of Jury Trial

Rather than employing a wholesale reference of all disputes with commercial borrowers to arbitration in place of traditional litigation, many lenders are now considering the use of jury trial waivers in loan documentation.[70] Unlike arbitration, however, such waivers are often ineffective and extremely dangerous for two main reasons. First, they are disfavored,[71] construed strictly, and often set aside.[72] If the waiver is not upheld, the jury may find out that the lender attempted to keep the dispute away from it, giving the borrower's counsel a powerful emotional argument.[73] Second, waiver of jury trial will at most be only partially effective to eliminate large awards in litigation, since several of the larger lender liability judgments have been entered by judges sitting without a jury.[74]

For those lenders that intend to use jury trial waivers, several considerations must be kept in mind. To begin with, such waivers will be

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[70] For an example of a successful motion to strike a jury trial demand based on such a waiver, see Appendix P *infra*.

[71] See:

Supreme Court: Aetna Insurance Co. v. Kennedy, 301 U.S. 389, 57 S.Ct. 809, 81 L.Ed. 1177 (1937).

Fourth Circuit: LaPosta v. Lyle, 2012 U.S.Dist. LEXIS 67898, at *28-30 (N.D. W. Va. May 16, 2012) (contractual waiver language ambiguous in scope is construed against jury waiver given strong policy in federal system favoring constitutional right to jury).

Third Circuit: First Union National Bank v. United States, 164 F. Supp.2d 660 (E.D. Pa. 2001) (there is a presumption against the validity of jury trial waivers; courts do not uphold such waivers lightly and the burden of proving that a waiver was made both knowingly and intelligently falls upon the party seeking enforcement of a waiver of a jury trial clause).

[72] *Second Circuit:* National Equipment Rental Ltd. v. Hendrix, 565 F.2d 255, 258 (2d Cir. 1977) (applying New York law).

Sixth Circuit: K.M.C. Co., Inc. v. Irving Trust Co., 757 F.2d 752 (6th Cir. 1985) (applying Tennessee law).

Tenth Circuit: Dreiling v. Peugeot Motors, 539 F. Supp. 402 (D. Col. 1982).

State Courts:

Texas: In re Credit Suisse First Boston Mortgage Capital, L.L.C., 257 S.W.3d 486 (Tex. App. 2008) (right to jury trial is so strongly favored that contractual jury waivers are strictly construed and will not be lightly inferred or extended).

[73] See K.M.C. Co., Inc. v. Irving Trust Co., 757 F.2d 752 (6th Cir. 1985) ($7.5 million jury verdict upheld).

[74] *Second Circuit:* Penthouse International Ltd. v. Dominion Federal Savings & Loan Ass'n, 855 F.2d 963 (2d Cir. 1988), *rev'd* 665 F. Supp. 301 (S.D.N.Y. 1987) ($129.9 million judgment).

State Courts:

Pennsylvania: Delahanty v. First Pennsylvania Bank, N.A., 318 Pa. Super. 90, 464 A.2d 1243 (1983).

upheld under federal law[75] and in many state courts only if they are knowing, voluntary and intentional.[76] If the waiver is buried deep in a lengthy loan agreement and is not known to the borrower,[77] or the

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[75] *Eleventh Circuit:* Acciard v. Whitney, 2011 WL 4902972 (M.D. Fla. Oct. 13, 2011) (to enforce jury trial waiver, waiver must have been assented to knowingly, voluntarily, and intelligently; in the case at bar, waiver provision in mortgage was identified with bold-faced heading, set forth in separately numbered paragraph contained in last paragraph of page immediately preceding borrowers' signature page, was in same font as remainder of document and consisted of unambiguous plain English; thus, court found waiver provision enforceable).

State Courts:

Massachusetts: Chase Commercial Corp. v. Owen, 32 Mass. App. 248, 588 N.E.2d 705 (1992) (noting that federal courts apply "a somewhat stricter standard for enforcement of contractual provisions waiving the right to jury trial than the one we have set forth").

[76] *Second Circuit:* National Equipment Rental, Ltd. v. Hendrix, 565 F.2d 255, 258 (2d Cir. 1977); N. Feldman & Son, Ltd. v. Checker Motors Corp., 572 F. Supp. 310 (S.D.N.Y. 1983).

Fourth Circuit: Leasing Service Corp. v. Crane, 804 F.2d 828, 832-833 (4th Cir. 1986).

Sixth Circuit: K.M.C. Co., Inc. v. Irving Trust Co., 757 F.2d 752 (6th Cir. 1985).

Seventh Circuit: In re Heartland Chemicals, Inc., 103 B.R. 1018, 1019-1020 (Bankr. C.D. Ill. 1989).

Ninth Circuit: Phoenix Leasing Inc. v. Sure Broadcasting, Inc., 843 F. Supp. 1379, 1384 (D. Nev. 1994), *aff'd* 89 F.3d 846 (9th Cir. 1996); Okura & Co. (America), Inc. v. The Careau Group, 783 F. Supp. 482, 488 (C.D. Cal. 1991).

Tenth Circuit: Dreiling v. Peugeot Motors, 539 F. Supp. 402, 403 (D. Col. 1982).

State Courts:

California: Trizec Properties, Inc. v. Superior Court, 229 Cal. App.3d 1616, 280 Cal. Rptr. 885 (1991).

Nevada: Lowe Enterprises Residential Partners, L.P. v. Eighth Judicial District Court of the State of Nevada, 40 P.3d 405 (Nev. 2002) (as a matter of first impression, court held that contractual jury trial waivers are enforceable when they are entered into knowingly, voluntarily and intentionally; court noted that federal district courts have overwhelmingly concluded that such waivers are valid and enforceable if knowingly, voluntarily and intentionally made and that many state courts have reached similar conclusions).

Texas: In re Credit Suisse First Boston Mortgage Capital, L.L.C., 257 S.W.3d 486 (Tex. App. 2008) (before jury waiver will be enforced, such waiver must be found to be voluntary, knowing, and intelligent act that was done with sufficient awareness of relevant circumstances and likely consequences).

[77] *Second Circuit:* National Equipment Rental, Ltd. v. Hendrix, 565 F.2d 255, 258 (2d Cir. 1977).

Seventh Circuit: In re Heartland Chemicals, Inc., 103 B.R. 1018 (Bankr. C.D. Ill. 1989) (provision contained in last sentence of paragraph captioned "Submission to Jurisdiction, Waiver of Bond," and blank for name of authorized agent not filled in).

Eighth Circuit: County 20 Storage & Transfer Inc. v. Wells Fargo Bank, NA, 2011 WL 826349, at *11 (D.N.D. March 3, 2011) (where jury waiver provision was, in essence, a "take-it-or-leave-it" adhesory provision of a contract inserted into a twenty-seven page complex financing agreement with no discussion as to the consequences, the court "would be hard-pressed to conclude that the waiver of a jury trial was made knowingly and voluntarily").

waiver results not from free choice but rather from an inequality in bargaining power,[78] it very well might not be enforced. Some courts have utilized a four-factor test to ascertain the validity of a jury trial waiver under federal law, focusing upon disparity in bargaining power, business experience of the borrower, ability to negotiate the provision, and the conspicuousness of the jury waiver clause.[79] Moreover, while the borrower who signs a jury waiver may have the burden of proving that his or her consent was not freely given,[80] he or she will not be bound by substantive contract law such as the parol evidence rule in proving lack of consent. This is because of the constitutionally protected nature of the right being waived.[81] Finally, many states[82] have

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Tenth Circuit: Dreiling v. Peugeot Motors, 539 F. Supp. 402, 403 (D. Col. 1982).

[78] *Second Circuit:* National Equipment Rental, Ltd. v. Hendrix, 565 F.2d 255, 258 (2d Cir. 1977).

Tenth Circuit: Dreiling v. Peugeot Motors, 539 F. Supp. 402, 403 (D. Col. 1982).

[79] *Second Circuit:* Allied Irish Banks, p.l.c. v. Bank of America, N.A., 875 F.Supp.2d 352, 355-356 (S.D.N.Y. July 12, 2012); Webster Chrysler Jeep, Inc. v. Chrysler Holding LLC, 2012 U.S. Dist. LEXIS 46264 (W.D.N.Y. March 30, 2012) (evidence in record was sufficient to prove that claimant "knowingly and intentionally" waived right to a jury).

Third Circuit: First Union National Bank v. United States, 164 F. Supp.2d 660 (E.D. Pa. 2001).

Ninth Circuit: Phoenix Leasing Inc. v. Sure Broadcasting, Inc., 843 F. Supp. 1379, 1384 (D. Nev. 1994).

Eleventh Circuit: Madura v. BAC Home Loans Servicing L.P., 851 F.Wupp.2d 1291 (M.D. 2012) (because no single factor is conclusive in determining whether waiver was knowingly and voluntarily made, court asks whether waiver is unconscionable, contrary to public policy, or simply unfair); Acciard v. Whitney, 2011 WL 4902972 (M.D. Fla. Oct. 13, 2011).

But see:

State Courts:

Alabama: Ex parte BancorpSouth Bank, 2012 WL 5077224 (Ala. Oct. 19, 2012) (court uses three-factor test: (1) whether waiver is buried deep in long contract; (2) whether bargaining power of parties is equal; and (3) whether waiver was intelligently and knowingly made).

[80] *Sixth Circuit:* K.M.C. Co. Inc. v. Irving Trust Co. 757 F.2d 752 (6th Cir. 1985).

Tenth Circuit: Dreiling v. Peugeot Motors, 539 F. Supp. 402, 403 (D. Col. 1982).

State Courts:

Texas: In re Wells Fargo Bank Minnesota N.A., 115 S.W.3d 600 (Tex. App. 2003) (contractual jury waiver is presumptively valid unless challenging party can prove it was not knowing, voluntary, or intentional; thus, when jury waivers explicitly stated they were given "knowingly and voluntarily" by the maker and guarantor of a mortgage, burden shifted to defendants to show they were not knowing and voluntary).

Contra, Leasing Service Corp. v. Crane, 804 F.2d 828, 833 (4th Cir. 1986) (party seeking enforcement must prove waiver was voluntary and informed).

[81] K.M.C. Co., Inc. v. Irving Trust Co., 757 F.2d 752 (6th Cir. 1985).

[82] See, e.g.:

Alabama: Ala. Const. Art. I, § 11, See also, SouthTrust Bank of Alabama, N.A. v. Cupps, 782 So.2d 772 (Ala. 2000) (tort claims did not "arise out of or relate to"

explicit constitutional or statutory guidelines which govern the waiver of the right to jury trial and these must be carefully consulted before drafting the proposed waiver.

Even when they are enforced, jury trial waivers will usually be limited to the borrower that executed a proper waiver, and will not bind guarantors unless they have signed a waiver in their personal capacity, or have executed the guaranty as part of an integrated transaction involving a loan agreement that contains a jury trial waiver.[83] Similarly, the courts have held that a lender may not invoke a jury waiver clause which appears in documentation relating to the transaction in question signed only by other participants, and not by the lender.[84] Further, a jury trial waiver embodied in loan agreement documents will be effective only as to claims that depend on the loan agreement

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a forbearance agreement; jury trial waiver applied to "any disputes arising under this Forbearance Agreement or the Loan Documents").

California: Cal. Code Civ. P. § 681.

Georgia: Ga. Const., 1983, Art. I, § 1, ¶ XI; OCGA § 9-11-38; Bank South, N.A. v. Howard, 444 S.E.2d 799 (Ga. 1994) (citing these provisions and holding that "prelitigation contractual waivers of jury trial are not provided for by our Constitution or Code and are not to be enforced in cases tried under the laws of Georgia").

Missouri: Mo. Ann. Stat. § 510.190; Mo. Ann. Rul § 69.01(b).

Pennsylvania: 42 Pa. Stat. § 5104(a).

But *cf.:*

Eleventh Circuit: Acciard v. Whitney, 2011 WL 4902972 (M.D. Fla. Oct. 13, 2011) (court found waiver provision to be clear and unambiguous); In re Evans, 2009 WL 1507419 (Bankr. N.D. Ala. May 26, 2009) (although Article I, § 11 of the Alabama Constitution provides "[t]hat the right of trial by jury shall remain inviolate" and Rule 38 of the Alabama Rules of Civil Procedure provides that "[t]he right of trial by jury as declared by the Constitution of Alabama or as given by a statute of this State shall be preserved to the parties inviolate," there is no prohibition on the waiver of a jury trial in Alabama; rather, in determining whether waiver is enforceable, Alabama courts look at three factors: (1) whether waiver is buried deep in a long contract; (2) whether the bargaining power of the parties is equal; and (3) whether waiver was intelligently and knowingly made).

[83] *Tenth Circuit:* Hulsey v. West, 966 F.2d 579 (10th Cir. 1992).

State Courts:

Massachusetts: Chase Commercial Corp. v. Owen, 32 Mass. App. 248, 588 N.E.2d 705 (1992).

New York: Chemical Bank v. Summers, 67 A.D.2d 856, 413 N.Y.S. 2d 148 (1979); Franklin National Bank v. Capobianco, 25 A.D.2d 445, 266 N.Y.S.2d 961 (1966).

Ohio: MidAm Bank v. Dolin, 2005 Ohio 3353, 2005 Ohio App. LEXIS 3122 (2005) (contractual jury waivers in loan guarantees are enforceable when terms of waiver are clear and unambiguous).

[84] See, e.g., Paracor Finance, Inc. v. General Electric Capital Corp., 96 F.3d 1151, 1166 (9th Cir. 1996). See also, In re Credit Suisse First Boston Mortgage Capital, L.L.C., 257 S.W.3d 486 (Tex. App. 2008) (contractual jury waiver did not encompass claims against nonsignatory lender; court declined request to use direct-benefits equitable estoppel as mechanism for extending reach of clause, i.e., as vehicle to circumvent required "knowing and voluntary" waiver standard).

documents, i.e., the factual allegations underlying the plaintiff's claims must arise from the parties' agreement in which the waiver is embodied.[84.1]

Jury trial waivers have been upheld in several federal and state cases which yield helpful guidelines for effective loan documentation.[85] First,

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[84.1] *Fourth Circuit:* LaPosta v. Lyle, 2012 WL 1752550 (N.D. W. Va. May 16, 2012) (waiver language must unambiguously cover the asserted claims).

Tenth Circuit: Capital Solutions, LLC v. Konica Minolta Business Solutions USA, Inc., 2008 WL 4683026 (D. Kan. 2008) (claims against bank for breach of fiduciary duty and conversion were not based on, nor did they relate to, loan documents so as to fall within jury waiver provision).

[85] *Second Circuit:* N. Feldman & Son, Ltd. v. Checker Motors Corp., 572 F. Supp. 310 (S.D.N.Y. 1983).

Fourth Circuit: Leasing Service Corp. v. Crane, 804 F.2d 828, 832-833 (4th Cir. 1986); Smith-Johnson Motor Corp. v. Hoffman Motors Corp., 411 F. Supp. 670, 675-677 (E.D. Va. 1975).

Ninth Circuit: Phoenix Leasing Inc. v. Sure Broadcasting, Inc., 843 F. Supp. 1379, 1384-1385 (D. Nev. 1994); Standard Wire & Cable Co. v. Ameritrust Corp., 697 F. Supp. 368, 375 (C.D. Cal. 1988).

Tenth Circuit: Telum, Inc. v. E.F. Hutton Credit Corp., 859 F.2d 835 (10th Cir. 1988) (Utah law).

Eleventh Circuit: In re Evans, 2009 WL 1507419 (Bankr. N.D. Ala. May 26, 2009) (under Alabama law, courts consider three factors in determining validity of jury waiver: (1) whether waiver is buried deep in a long contract; (2) whether the bargaining power of the parties is equal; and (3) whether waiver was intelligently and knowingly made).

State Courts:

Nevada: Lowe Enterprises Residential Partners, L.P. v. Eighth Judicial District Court of the State of Nevada, 40 P.3d 405 (Nev. 2002) (as a matter of first impression, court held that contractual jury trial waivers are enforceable when they are entered into knowingly, voluntarily and intentionally; moreover, in accordance with Nevada's public policy favoring the enforceability of contracts, contractual jury trial waivers are presumptively valid unless the challenging party can demonstrate that the waiver was not entered into knowingly, voluntarily or intentionally).

New Jersey: Investors Savings Bank v. Waldo Jersey City, LLC, 418 N.J. Super. 149, 12 A.3d 264 (2011) (jury trial waiver that was contained in bold and conspicuous print in a construction loan agreement and a mortgage and security agreement was enforceable in lender's mortgage foreclosure action, since the provision did not conflict with any public policy, and there was no demonstration that the waiver was involuntary or unknowing).

New York: Chemical Bank v. Summers, 67 A.D. 2d 856, 413 N.Y.S.2d 148 (1979).

Texas: In re Credit Suisse First Boston Mortgage Capital, L.L.C., 257 S.W.3d 486, 490 (Tex. App. 2008) ("Before a jury waiver will be enforced, such waiver must be found to be a voluntary, knowing, and intelligent act that was done with sufficient awareness of the relevant circumstances and likely consequences."); In re Wells Fargo Bank Minnesota N.A., 115 S.W.3d 600 (Tex. App. 2003) (court held as matter of first impression that jury waivers are enforceable in Texas; thus, contractual waivers of the right to a jury trial contained in mortgage note and guarantee were enforceable in collection action brought by bank against maker and guarantor).

See generally, Annotation, "Validity and Effect of Contractual Waiver of Trial by Jury," 73 A.L.R. 2d 1332 (1960).

the waiver should be conspicuous,[86] either set forth directly above the signature lines,[87] preferably in boldface, or set forth in a separate document. Second, reasons for the waiver should be included, to enhance the likelihood of enforcement and to provide an explanation to the jury where the waiver is not upheld. One such waiver which was upheld provided that:

> "[Lender and Borrower] both acknowledge and agree that any controversy which may arise under this agreement or the relationship established hereby would be based upon difficult and complex issues, and therefore, the parties agree that any law suit growing out of any such controversy will be tried in a court of competent jurisdiction by a judge sitting without a jury."[88]

Such language could be augmented by referring to a desire to avoid delays, minimize the expense of trial and streamline the proceedings. Third, the waiver should extend to all actions, proceedings or counterclaims arising out of or relating to the loan agreement or any related documents, or to the actions of the lender in the enforcement thereof.[89]

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[86] Trizec Properties, Inc. v. Superior Court, 229 Cal. App.3d 1616, 280 Cal. Rptr. 885 (1991) (". . . to be enforceable, the waiver provision must be clearly apparent in the contract and its language must be unambiguous and unequivocal, leaving no room for doubt as to the intention of the parties"). See also, Phoenix Leasing Inc. v. Sure Broadcasting, Inc., 843 F. Supp. 1379, 1384 (D. Nev. 1994).

Cf., Peters v. Farmers & Merchants Bank of Long Beach, 2001 WL 1191477 (Cal. App. Oct. 1, 2001) (plaintiff claimed waiver language was "hidden" in text of contract, but where document was only one page long, and waiver clause was printed in same size type as rest of text, notice was adequate to make plaintiff aware that parties were waiving their rights to jury trial).

[87] *Second Circuit:* N. Feldman & Son, Ltd. v. Checker Motors Corp., 572 F. Supp. 310, 312 (S.D.N.Y. 1983).

Ninth Circuit: Phoenix Leasing Inc. v. Sure Broadcasting, Inc., 843 F. Supp. 1379, 1384 (D. Nev. 1994).

[88] *Id*. See also, e.g., Jaffe v. Bank of America, N.A., 395 Fed. Appx. 583, 586 (11th 2010) (district court's decision to hold bench trial did not violate plaintiffs' right to jury because on three occasions plaintiffs signed contractual waivers having language that was unequivocal).

[89] *Ninth Circuit:* Phoenix Leasing Inc. v. Sure Broadcasting, Inc., 843 F. Supp. 1379, 1388-1390 (D. Nev. 1994) (scope of jury trial waiver was determined by standard of "[i]f determination of an action would require reference to, or if the action relates to or pertains to the loan documents covered by the waiver, then such action is 'with respect to' the loan documents and the jury waiver provision applies"). See also, Okura & Co. (America), Inc. v. The Careau Group, 783 F. Supp. 482, 488 (C.D. Cal. 1991).

State Courts:

Alabama: Ex parte BancorpSouth Bank, 2012 WL 5077224 (Ala. Oct. 19, 2012) (jury-trial waiver language clearly applied to all of plaintiff's allegations "in any way

The enforceability of a jury trial waiver may also be increased by including a provision reciting the opinion of borrower's counsel, or securing a written acknowledgment by the borrower, that the effect of the waiver was explained to the borrower.[90] Finally, when such a provision was not included in the original loan documentation, lenders should consider including a jury trial waiver in amended loan agreements, particularly if concessions, such as on interest rate or repayment date, are being extended to the borrower.

[d]—Choice of Forum

Since the repeal of the special venue provision of the National Bank Act, national banks, as well as other lenders doing business with out of state borrowers, are now faced with the prospect of multimillion dollar lawsuits in foreign jurisdictions, often with large awards made in favor of a local borrower.[91] Such lawsuits often deprive the

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connected with" guaranty agreements, "the transaction(s) related hereto," or "the debtor-creditor relationship" created by guaranty agreement, thus encompassing all of plaintiff's claims).

Cf.:

State Courts:

Alabama: Ex parte Cupps, 782 So.2d 772 (Ala. 2000) (jury waiver clause in loan agreement applied only to claims alleging breach of the agreement, and *not* to tort claims for fraud in the inducement, fraudulent suppression, and intentional interference with contractual relations, as such claims did not require reference to, or construction of, the agreement or the loan documents).

[90] *Ninth Circuit:* Phoenix Leasing Inc. v. Sure Broadcasting, Inc., 843 F. Supp. 1379, 1383 (D. Nev. 1994) (jury waiver provision recited borrower was advised by counsel); Standard Wire & Cable Co. v. Ameritrust Corp., 697 F. Supp. 368, 375 (C.D. Cal. 1988) (jury waiver upheld against guarantors where their counsel had reviewed all loan documents before they signed).

Tenth Circuit: Telum, Inc. v. E.F. Hutton Credit Corp., 859 F.2d 835 (10th Cir. 1988) (enforcing jury trial waiver in normal print because both parties were "sophisticated").

State Courts:

Massachusetts: Chase Commercial Corp. v. Owen, 32 Mass. App. Ct. 248, 588 N.E. 2d 705 (1992) (enforcing jury trial waiver contained in loan agreements against guarantors who did not sign such agreements personally: court relied on facts that waivers were set forth on the signature pages of the loan agreements; the guarantors were the principals of the borrower; and the guarantors were "experienced businessmen" and "were represented by counsel who reviewed the documents before they were signed").

Nevada: Lowe Enterprises Residential Partners, L.P. v. Eighth Judicial District Court of the State of Nevada, 40 P.3d 405 (Nev. 2002) (factors to consider in determining whether a contractual waiver of the right to jury trial was entered into knowingly and voluntarily include: (1) the parties' negotiations concerning the waiver provision, if any, (2) the conspicuousness of the provision, (3) the relative bargaining power of the parties, and (4) whether the waiving party's counsel had an opportunity to review the agreement).

[91] See, e.g.: K.M.C. Co., Inc. v. Irving Trust Co., 757 F.2d 752 (6th Cir. 1985) ($7.5 million verdict upheld against New York bank in favor of Tennessee borrower);

lender of cost effective access to its regular local counsel, who is familiar with bank personnel and procedures. In addition the costs and inconvenience of litigation are increased, particularly at the trial stage, where live testimony by bank officers is the most effective method of presentation.

To avoid the added inconvenience, expense and risk of litigating in a foreign jurisdiction, lenders should include a restrictive choice of forum provision in the loan documentation. These provisions are presumptively valid under federal law, and will be enforced between businessmen in commercial transactions unless they (1) result from fraud or overreaching, (2) would violate a strong public policy of the forum, or (3) would result in such inconvenience as to be unreasonable.[92] Federal courts will consider contractual limitations on forum not only in federal question cases, but also in diversity cases, even where the forum or governing state law holds such clauses to violate public policy,[93] and in bankruptcy cases.[94] The inconvenience which must be

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Scharenberg v. Continental Illinois National Bank, No. 87-0238-CIV-DAVIS (consolidated) (S.D. Fla. Jul. 1, 1987) ($105 million jury verdict against Illinois bank in favor of Florida borrower).

[92] *Supreme Court:* Carnival Cruise Lines, Inc. v. Shute, 499 U.S. 585, 111 S.Ct. 1522, 113 L. Ed.2d 622 (1991); M/S Bremen v. Zapata Off-Shore Co., 407 U.S. 1, 92 S. Ct. 1907, 32 L.Ed.2d 513 (1972) (applying admiralty law).

Second Circuit: Evolution Online Systems, Inc. v. Koninklijke PTT Nederland N.V., 145 F.3d 505, 509-511 (2d Cir. 1998); HongKong and Shanghai Banking Corp. Ltd. v. Suveyke, 392 F. Supp.2d 489 (E.D.N.Y. 2005) (international forum selection clauses are presumed to be valid; such clauses should be enforced unless the party opposing enforcement can clearly show that enforcement would be unreasonable and unjust, or that the clause was invalid for such reasons as fraud or overreaching); Seward v. Devine, 888 F.2d 957 (2d Cir. 1989); Medoil Corp. v. Citicorp, 729 F. Supp. 1456 (S.D.N.Y. 1990).

Third Circuit: Coastal Steel Corp. v. Tilghman Wheelabrator, Ltd., 709 F.2d 190 (3d Cir.), *cert. denied* 464 U.S. 938 (1983).

Seventh Circuit: Goldberg Brothers Commodities, Inc. v. Duffeck, No. 87C 6877 (N.D. Ill. Mar. 2, 1988).

Ninth Circuit: Jones v. GNC Franchising, Inc., 211 F.3d 495 (9th Cir. 2000).

State Courts:

Vermont: Bense v. Interstate Battery System, Inc., 683 F.2d 718 (2d Cir. 1982) (applying Vermont law).

West Virginia: Mercury Coal & Coke, Inc. v. Mannesmann Pipe & Steel Corp., 696 F.2d 315, 317 (4th Cir. 1982) (applying West Virginia law).

See generally, Annotation, "Validity of Contractual Provision Limiting Place or Court in Which Action May Be Brought," 31 A.L.R. 4th 404 (1984).

[93] *Supreme Court:* Stewart Organization, Inc. v. Ricoh Corp., 487 U.S. 22, 108 S.Ct. 2239. 101 L.Ed.2d, 22 (1988) (refusing to apply Alabama law disfavoring forum selection clauses, and holding that forum selection clause should be considered by federal courts as a factor on transfer motions).

Second Circuit: Bense v. Interstate Battery System, Inc., 683 F.2d 718 (2d Cir. 1982) (refusing to apply Texas law disfavoring forum selection clauses).

[94] In Re Diaz Contracting, Inc., 817 F.2d 1047, 1050 (3d Cir. 1987) (New Jersey law).

demonstrated to avoid a contractual limitation on forum under federal law must be such as to "show that trial in the contractual forum will be [so] gravely difficult and inconvenient that [the party] will for all practical purposes be deprived of his day in court."[95] Finally, the forum limitation will be applied not only to suits based directly on the contract containing the forum selection clause, but also to suits based on tort or statutory claims arising out of the contractual relationship.[96]

While federal courts are thus receptive to enforcing contractual limitations on forum in business disputes, there are several important exceptions which must be kept in mind in drafting such provisions. First, many states by judicial decision or by statute disfavor forum restrictions, and state courts applying these laws may invalidate the provision on public policy grounds.[97] Second, one federal court exercising jurisdiction under the Racketeer Influenced and Corrupt Organizations Act[97.1] ("RICO") has held that RICO's nationwide venue provision required the court to disregard a forum selection clause.[98] Third, given the strong federal policies in favor of arbitration, the Third Circuit has held that unless it contains an express waiver of

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[95] *Supreme Court:* M/S Bremen v. Zapata Off-Shore Co., 407 U.S. 1, 18, 92 S. Ct. 1907, 32 L.Ed.2d 513 (1972) (applying admiralty law). See also, Carnival Cruise Lines, Inc. v. Shute, 499 U.S. 585, 111 S.Ct. 1522, 113 L.Ed.2d 622 (1991).

Second Circuit: Medoil Corp. v. Citicorp, 729 F. Supp. 1456 (S.D.N.Y. 1990).

[96] *Second Circuit:* Bense v. Interstate Battery System, Inc., 683 F.2d 718 (2d Cir. 1982) (antitrust claim).

Third Circuit: Crescent International, Inc. v. Avatar Communities, Inc., 857 F.2d 943 (3d Cir. 1988) (RICO and business torts claims) (applying Pennsylvania law).

[97] See cases cited in N. 93, *supra*. See also:

Ninth Circuit: Jones v. GNC Franchising, Inc., 211 F.3d 495 (9th Cir. 2000) (concluding that California franchising statute, which voids any clause in a franchise agreement limiting venue to a non-California forum for claims arising under or related to a California franchise, expresses a strong public policy of California to protect its franchisees from the expense, inconvenience and possible prejudice of litigating in a non-California venue and therefore such a provision is unenforceable under the directives of the *M/S Bremen* case, N. 92 *supra*).

State Courts:

Alabama: Keelean v. Central Bank, 544 So.2d 153 (Ala. 1989) (invalidating forum selection clause as contrary to public policy).

See also, Annotation, "Validity of Contractual Provision Limiting Place or Court in Which Action May Be Brought," 31 A.L.R. 4th 404, 449 (1984).

[97.1] Pub. L. No. 91-452, 84 Stat. 941 (Oct. 15, 1970); 18 U.S.C. § 1961 note.

[98] Snider v. Lone Star Art Trading Co., Inc., 659 F. Supp. 1249, 1257-1258 (E.D. Mich. 1987), *on rehearing* 672 F. Supp. 977 (E.D. Mich. 1987), *aff'd* 838 F.2d 1215 (6th Cir. 1988) (order) (applying Michigan law). Other cases have upheld forum selection clauses as applied to RICO claims. See, e.g.:

Second Circuit: Seward v. Devine, 888 F.2d 957 (2d Cir. 1989); Medoil Corp. v. Citicorp, 729 F. Supp. 1456 (S.D.N.Y. 1990).

Third Circuit: Crescent International, Inc. v. Avatar Communities, Inc., 857 F.2d 943 (3d Cir. 1988).

arbitration rights, a forum selection clause will not divest a party of a contractual remedy to arbitrate a dispute.[99]

Careful draftsmanship is required to insure that a forum selection clause limits jurisdiction over all disputes to the chosen forum. Thus, such a clause should be drafted to cover the following points:

(1) The chosen forum's jurisdiction must be exclusive, rather than only concurrent;[100]

(2) If access is desired only to the state or federal courts in the chosen forum, this must be covered specifically;[101]

(3) If access is to be limited to a particular court in a particular city, this must be covered specifically;[102]

(4) To avoid questions as to whether any particular type of dispute falls within the forum selection clause, it should provide that any and all disputes between the parties relating directly or indirectly to the financing or any term thereof are covered, and any general right of arbitration which may otherwise exist should be specifically mentioned as falling within the clause;

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[99] Pattern Securities Corp., Inc. v. Diamond Greyhound & Genetics, Inc., 819 F.2d 400, 406-407 (3d Cir. 1987) (applying New Jersey law).

[100] *Third Circuit:* Nova Ribbon Products, Inc. v. Lincoln Ribbon, Inc., C.A. No. 89-4340 (E.D. Pa. Dec. 14, 1992) (provision that "The courts of New York and the United States District Courts for New York shall have jurisdiction over the parties with respect to any dispute or controversy between them arising under or in connection with this agreement" is not exclusive); Webb Research Corp. v. Rockland Industries, Inc., 580 F. Supp. 990, 993 (E.D. Pa. 1983) (requirement that parties "submit to the jurisdiction of the state and federal courts of Maryland" does not preclude suit elsewhere).

Sixth Circuit: Regis Associates v. Rank Hotels (Management), Ltd., 894 F.2d 193 (6th Cir. 1990) (provision that "the parties hereby submit to the jurisdiction of the Michigan Courts" did not preclude removal of an action from state to federal court in that state).

Eleventh Circuit: Links Design, Inc. v. Lahr, 731 F. Supp. 1535 (M.D. Fla. 1990) (provision that "proper venue for said action shall be in Folk County, Florida" does not preclude removal to federal court).

[101] *Compare*, Regis Associates v. Rank Hotels (Management), Ltd., 894 F.2d 193 (6th Cir. 1990) (provision that "the parties hereby submit to the jurisdiction of the Michigan Courts" did not preclude removal to federal court) *and* BlueTarp Financial, Inc. v. Melloul Blamey Construction S.C., Ltd., 2012 WL 688299 (D. Me. March 1, 2012) (binding forum selection clause permitted removal to federal system within state) *with* Spatz v. Nascone, 364 F. Supp. 967 (W.D. Pa. 1973) (clause providing for disputes to be "tried in the Courts of the Commonwealth of Pennsylvania" restricts forum to state courts only).

[102] Stewart Organization, Inc. v. Ricoh Corp., 487 U.S. 22, 108 S. Ct. 2239, 101 L.Ed. 2d 22 (1988) (provision limited suit to courts in New York City, the Borough of Manhattan).

(5) The contracting parties should specifically waive any right to move to transfer or to remove any action to a different forum.[103] This will be effective in most federal court cases to preclude a transfer, although the federal court is not permitted to treat the forum selection clause as dispositive, and must also consider the convenience of the witnesses and the interests of justice in deciding whether transfer to a different forum is appropriate;[104] and

(6) As with jury waivers, the reasons for imposing restrictions on available fora should be recited in the forum selection clause.

(7) The clause should appear either in a conspicuous place in the loan documentation or in a separate document.[105] Finally, exercise of personal jurisdiction over the borrower in accordance with the terms of a forum selection provision must comport with the Due Process Clause of the Fourteen Amendment.[105.1]

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[103] Goldberg Brothers Commodities, Inc. v. Duffeck, No. 87C 6877 (N.D. Ill. Mar. 2, 1988) (denying transfer and enforcing forum selection clause which provided in part that "All actions or proceedings arising with respect to any controversy arising out of this Agreement . . . shall be litigated, . . . only in courts whose situs is within the State of Illinois and Customer hereby submits to the jurisdiction of the courts of the State of Illinois and the jurisdiction of the United States District Court for the Northern District of Illinois, Eastern Division . . . Customer waives any right Customer may have to transfer or change the venue of any litigation brought against Customer by Broker."). See also:

Third Circuit: Foster v. Chesapeake Insurance Co., Ltd., 933 F.2d 1207, 1216-1219 (3d Cir. 1991) (forum selection clause requiring reinsurer to "submit to the jurisdiction of any court of competent jurisdiction within the United States" construed to effectuate waiver of right to remove case from state to federal court).

Sixth Circuit: Regis Associates v. Rank Hotels (Management), Ltd., 894 F.2d 193 (6th Cir. 1990).

[104] *Supreme Court:* Stewart Organization Inc. v. Ricoh Corp., 487 U.S. 22, 108 S.Ct. 2239, 101 L.Ed. 2d 22 (1988).

Seventh Circuit: Goldberg Brothers Commodities, Inc. v. Duffeck, No. 87C 6877 (N.D. Ill. Mar. 2, 1988).

Ninth Circuit: Jones v. GNC Franchising, Inc., 211 F.3d 495 (9th Cir. 2000).

See also, Jordan & Hackett, "Drafter Beware: Forum Selection Clauses May Not Achieve Their Goal," Pa. Bar Ass'n. Q. 101, 104 (July 1994) (collecting cases granting and denying transfer where forum selection clause was implicated, and recommending inclusion of provisions in contract (1) noting both parties' agreement that the chosen forum is the most convenient, and (2) admitting that witnesses and documents are located in the selected forum, and that any other forum will pose an inconvenience to both parties).

[105] Goldberg Brothers Commodities, Inc. v. Duffeck, No. 87C 6877 (N.D. Ill. Mar. 2, 1988) (clause enforced where "defendant has separately signed a consent to jurisdiction that has been set apart from the rest of the contract. The position of the clause in the contract and the requirement of a separate signature should alert potential plaintiffs to the importance of the provision.").

[105.1] BlueTarp Financial, Inc. v. Melloul Blamey Const.ruction S.C., Ltd., 2012 WL 688299 (D. Me. March 1, 2012) (insufficient contacts with forum for court to reasonable exercise specific personal jurisdiction).

[e]—Choice of Law

As the substantive chapters of this book will demonstrate in detail, lender liability theories vary dramatically from state to state on such fundamental points as the elements of a cause of action, the sufficiency of the evidence and the burden of proof, and the availability of punitive damages. Therefore, lenders are well advised to specify in their loan documentation, beginning with any commitment letter, the choice of a controlling substantive law[106] to govern any and all disputes between the parties arising directly or indirectly under the loan documentation or from the financing relationship. Such a choice of law provision likely will be upheld if the jurisdiction the law of which is selected bears a reasonable relationship to the transaction, which will be the case if the jurisdiction is that in which the agreement was made or is to be performed, or in which the lender has its principal place of business.[107]

However, notwithstanding the inclusion of a "choice of law" provision in a loan agreement, it will not be enforced if it is determined to be contrary to a fundamental policy of the chosen state (or of another state the law of which would apply in the absence of the choice of law provision, if that state has a materially greater interest

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[106] Reference should be made to the substantive laws of the selected jurisdiction to avoid application of the jurisdiction's choice of law rules. For a suggested provision which addresses this important issue, see North, "Drafting Loan Documents to Minimize Lender Liability," Lender Liability: Theories and Practice 97, 111 (Pa. Bar Institute 1988).

[107] *Restatement (Second) Conflict of Laws* § 187(2); U.C.C. § 1-105. See, e.g.:

Second Circuit: Unicredito Italiano SpA v. JP Morgan Chase Bank, 2003 WL 22339469 (S.D.N.Y. Oct. 14, 2003) (credit agreements provided that they would be governed by New York law and parties presumed in their arguments that New York law governed action, and thus court applied New York law in rendering its decision).

Sixth Circuit: Wallace Hardware Co. Inc. v. Abrams, 223 F.3d 382 (6th Cir. 2000).

Compare:

Third Circuit: Nova Ribbon Products, Inc. v. Lincoln Ribbon, Inc., C.A. No. 89-4340 (E.D. Pa. Dec. 14, 1992) (refusing to apply contractual choice of law because none of the parties to the agreement resided in the state selected and that state had no connection with the making or performance of the contract). The courts have also held that a lender may not rely on a choice of law provision to which it was not a signatory, even when that provision appeared in contractual documents relating to the same transaction, signed by other parties to the transaction.

Ninth Circuit: Paracor Finance Inc. v. General Electric Capital Corp., 79 F.3d 878, 891-893 (9th Cir. 1996).

State Courts:

California: Klussman v. Cross Country Bank, 134 Cal. App.4th 1283, 36 Cal. Rptr.3d 728 (2005) (court refused to enforce choice of law provision because chosen state's law was contrary to a fundamental policy of California).

in the determination of the particular issue than the chosen state).[108] Thus, for example, in a case in which the plaintiff, a Pennsylvania resident who worked in Delaware, obtained a "car title loan" carrying an annual interest rate of 300.01% from a Delaware bank that was approximately one mile from the Pennsylvania border, the court held that under Pennsylvania's choice of law rules (which governed because it was to a Pennsylvania federal district court that the lender had removed the action), application of Delaware law to the determination of whether the loan's arbitration clause was unconscionable would have been contrary to fundamental policy of Pennsylvania in light of Pennsylvania's antipathy to high interest rates.[109]

Because lender liability theories vary across the states, conflict of laws analyses may defeat class certification. In *Yarger v. ING*,[110] mortgagor/borrowers sought class action status to sue mortgagee/lender under the TLA, and theories of fraud and fair dealing. While the mortgage instruments required application of the borrowers' home state laws, it was subsequent loan modification agreements that were at the heart of the controversy.[111] The court applied a choice of law analysis on a claim-by-claim basis because neither party persuasively argued for the application of a single state's law.

Save for one claim, the court denied certification on two bases.[112] First, monetary rewards, or in the alternative, injunctive relief could not flow to the class as a whole as damages would have to be determined on an individual basis.[113] Second, the court found no single case management strategy superior to litigating the materially different state law claims individually.[113]

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[108] See, e.g., Cicle v. Chase Bank USA, 583 F.3d 549 (8th Cir. 2009) (applying Missouri law) (a choice of law clause in a contract generally is enforceable unless application of the agreed-to law is contrary to a fundamental policy of Missouri).

[109] Kaneff v. Delaware Title Loans, Inc., 587 F.3d 616 (3d Cir. 2009) (Pennsylvania's interest in the dispute, particularly its antipathy to high interest rates such as the 300.01% annual interest charged in the contract at issue, represented such a fundamental policy that it was necessary to apply Pennsylvania law—however, since the *agreement to arbitrate* was not unconscionable under Pennsylvania law, it was enforced and the issue of the contract's validity was for the arbitrator to decide in the first instance.).

[110] Yarger v. ING Bank, 285 F.R.D. 308 (D. Del. 2012), *reconsideration denied* (Oct. 9, 2012).

[111] 285 F.R.D. 308, 322.

[112] Fed. R. Civ. P. 23(b)(2) and 23(b)(3).

[113] 285 F.R.D. at 322.

[113] 285 F.R.D. at 322-330.