THE TORT OF BAD FAITH BREACH AS AN EMERGING THEORY OF LENDER LIABILITY: EXPLORING PHILIPPINE ANALOGUES OF THE CALIFORNIA AND MONTANA DOCTRINES*

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I. INTRODUCTION

A. Preliminary Considerations

Lender liability, a rubric of recent coinage, is the body of judicial doctrines which, starting with heretofore sporadic and unheralded judgments rendered in favor of borrowers in suits pitting them against institutional lenders, grew exponentially in various United States jurisdictions into a distinct subset of private law in the early 1980s.[1] Its emergence has reconfigured the traditional legal relationship between borrowers and banks[2] or other commercial lending institutions.[3] Moreover, the ratiocination involved in the various legal theories used to hold such lenders liable reveals an increasing judicial solicitude for the welfare of distressed or defaulting borrowers who sue or counter-sue for supposed contractual breach, tortious conduct or violation of a statute rather than give in to these lenders' impositions as they in the past were wont to do. These theories, reflective of growing paternalism in

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1 While isolated lender liability cases had been decided earlier, it was State National Bank of El Paso v. Farah Manufacturing Company (Tex App. 1984), 678 S.W.2d 661, with its staggering S19 Million judgment award, which attracted public attention. *See* A. B. CAPPELLO, LENDER LIABILITY xvii (1987) and Moss, *Borrowers Fight Back With Lender Liability*, A.B.A.J., March 1, 1987, at 64, 66.

2 Under the Federal Bank Holding Company Act of 1956, a "bank" is an institution that extends commercial loans and takes deposits which are payable on demand. *See* 12 U.S.C. Sec. 1841(c) (1956). Under The General Banking Act of the Philippines, banks are defined as institutions "engage[d] in the lending of funds obtained from the public through the receipt of deposits of any kind and all entities regularly conducting such operation." *See* THE GENERAL BANKING ACT (Republic Act No. 337), sec. 2 (1948). *See also* SCHLICTING, RICE & COOPER, 1 BANKING LAW Sec. 1.03(2) (1988); Ebke & Griffin, *Lender Liability to Debtors: Toward a Conceptual Framework*, 40 S.W.L.J. 775, at note 2 (1986); Felsenfeld, *Nonbank Banks--An Issue in Need of a Policy*, 41 BUS. LAW. 99, 108-11 (1985).

3 See J. NORTON & S. WHITLEY, BANKING LAW MANUAL Sec. 1.03[3] (1984).

contemporary juristic thinking, are among the most exuberant of the many tendrils of American liability law creeping into the realm of contract law. The upshot of these judgments has been unprecedented and phenomenal. Given their increasing frequency and the heftiness of the concomitant awards in damages,[4] dramatic indeed has been the erosion of the orthodox arguments that reify lenders' expectations of being repaid strictly according to the tenor of the loan agreement.

Under a regime of absolute party autonomy, the written contract is the law between the parties. That the playing field might have been tilted in favor of the lender need not detract from the cold neutrality which the court must assume in resolving a dispute between the parties. Wooden adherence to legal formalism, a prominent feature of this regime, translates the lender's superior bargaining power into an advantage that is predictably unfair, inequitable and unconscionable. Lender liability presents the antithesis of this regime. It is a shift towards an antipodal rhetorical mode according to which the lender's superior bargaining power, when used to exact such an advantage, warrants judicial intervention. As a result, altruistic sentiments extenuate the onerous prestations of the borrower while the need for exemplarity entails the imposition of tariffs on the peccant lender in the form of punitive damages.

Lender liability, it is said, evokes "fear and mystery".[5] The fear is due to the intrusion of a non-party, the court, into what the parties have presumably structured according to calibrated self-interest. The mystery comes from some of the theories' recourse to *ad hoc* and open-ended analyses based on standards that entail the wide-ranging exercise of discretion. Nowhere have such fear and mystery been more palpable than in regard to the most controversial among the theories, one poised at the very cutting edge of private law especially in the jurisdictions of California and Montana--the tort theory based on the

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[4] A. B. CAPPELLO, LENDER LIABILITY xvii (1987). In 1987 six of the ten biggest court awards in the United States came in suits pitting borrowers against institutional lenders; one involved *Penthouse* magazine which obtained an award in damages amounting to $129 Million. *See* Penthouse International, Inc. v. Dominion Federal Savings & Loan Association, (S.D.N.Y. 1987) 665 F. Supp. 301. However, on appeal, the United States Court of Appeals reversed on the ground *inter alia* that the borrowers had failed to establish their ability to perform their contractual obligations and that, therefore, the lenders were not guilty of anticipatory breach. *See* Penthouse International, Ltd. v. Dominion Federal Savings & Loan Association, 855 F. 2d 963 (1988). *See also "Lender Liability": The Next Big Area For Your Firm?*, 7 LAW. ALERT, Sept. 5, 1988, at 4, 5.

[5] Ebke & Griffin, *Lender Liability to Debtors: Toward a Conceptual Framework*, 40 S. W. L. J. 775, 776 (1986).

breach of the implied covenant of good faith and fair dealing, which shall alternatively be referred to as the tort of bad faith breach.

Lender liability is archetypical of the living law. Its societal matrix is the constant flux and endless permutations of America's credit-based, capitalist economy.[6] Market forces, influenced by the tension between individualism and altruism, two competing ideological visions and rhetorical modes, continue to shape its still uncertain topography. Possibly acting as catalyst is the inordinate litigiousness of American society.[7]

Where a comparable environmental matrix exists, lender liability, if consistent with the legal order, may with time emerge. The Philippines manifests many of the same environmental determinants that contributed to the rise of lender liability law in the United States. Moreover, it is possessed of a legal system that is exceptionally conducive to the parallel evolution of lender liability. That is the starting proposition of this paper. Thence, it proceeds to break fresh ground by showing that: (1) lender liability, though unknown in the Philippines, is not unintegrable into the latter's legal system considering that certain socio-economic events taking place during the past forty years resemble those foreshadowing the emergence of lender liability in the United States; (2) there is a slowly crystallizing theory grounded in tort arising from the implied covenant of good faith and fair dealing as construed in California and Montana; (3) certain tort and contract law provisions of the Civil Code of the Philippines embody legal principles analogous to the California and Montana tort theories of bad faith breach; and (4) discernible shifts in ideological and rhetorical bias from individualism to altruism make the internalization of lender liability law inevitable and desirable. In arguing these propositions, it will be necessary to analyze and compare the tort theories of bad faith breach in California and Montana and to propose an analytical framework for their application in the Philippines.

B. *Overview: Other Theories of Lender Liability*

Lender liability can be predicated on any of a number of statutory and common law theories. These theories are part of an expanding constellation of claims, a rather intimidating legal arsenal at the disposal of one seeking to cross swords with a lending institution. So

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6 From 1945 to September 1987, total consumer credits rose from $5.7 Billion to $602.2 Billion while home mortgage debt increased from $24.3 Billion to $2.1 Trillion. *See* 74 FED. RES. BULL. A 38, A 40 (Sept. 1987).

7 *See* Samuelson, *The Lawyering of America*, NEWSWEEK, Mar. 10, 1986, at 66.

multi-faceted is the typical relationship between a lending institution and its customer that the latter, if truly aggrieved, would not be hard pressed to find a theory that suits him.

1. Statutory Theories

The statutory theories, coextensive only with the stream of federal and state laws enacted to regulate the lending industry, are potentially unlimited in number.[8] They are as disparate as the different statutes invoked to hold lenders liable. Federal laws provide fertile ground. Section 510(c) of the Bankruptcy Code, embodying the doctrine of equitable subordination--which excepts from the basic principle of parity of distribution among a bankrupt's creditors and subordinates the claim of one who has engaged in "some form of inequitable or fraudulent conduct" resulting in "injury to the bankrupt's other creditors" or "unfair advantage to himself", provided the subordination is not "inconsistent with bankruptcy law"[9]--has been successfully used to ensure that "injustice or unfairness is not done in the administration of the bankrupt estate"[10] where the creditor's fraudulent conduct with respect to its security interests, the bankrupt and the other creditors, or his excessive control or domination of the bankrupt's business has occasioned egregious harm to the latter.[11]

The "elastic reasoning"[12] often used to justify the ever-widening breadth of the Racketeer Influenced and Corrupt Organizations Act,[13]

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[8] A. B. CAPELLO, LENDER LIABILITY 236 (1987).

[9] Pepper v. Litton, 308 U.S. 295, 60 S.Ct. 238 (1939). *See In Re* Kansas City Journal-Post Co. (8th Cir. 1949), 144 F.2d 791, 804.

[10] Pepper v. Litton, *supra* note 9, at 308.

[11] *See In Re* Harvest Milling Co. (D. Ore. 1963), 221 F.Supp. 836, 838; *In Re* Beverages International, Ltd. (Bankr. D. Mass. 1985), 50 B.R. 273 (where the creditor's security interest was avoided and its claim subordinated after the creditor was found to have abused its control and domination of the bankrupt leading to the latter's financial ruin and to the other creditors' prejudice); *In Re* Process-Manz Press, Inc. (N.D. Ill. 1964), 236 F. Supp. 333 (where the creditor who despoiled the debtor's capital stock in breach of the fiduciary duties it assumed by controlling said business had its claims subordinated to that of the other creditors). As to how the courts have defined what degree of control creates a fiduciary duty, *see* Taylor v. Standard Gas & Electric Co. 306 U.S. 307, 353, 59 S.Ct. 543 (1939) . A. B. CAPPELLO, *supra* note 8, at 254-60 has a fairly illustrative survey of the cases applying the principle of equitable subordination.

[12] *Mario Cuomo, Racketeer*, WALL ST. J., Mar. 9, 1989 at A 16, col. 1.

[13] 18 U. S. C. Sec. 1962 (a) (1976).

See also Mannino, Prime Rate Overchange Cases: How to Exorcise the RICO Devil, 101 BANKING L. J. 196 (1984).

AMERICAN BAR ASSOCIATION, 1 EMERGING THEORIES OF LENDER LIABILITY (1985) contains a sizeable survey of lender liability RICO cases. *See also* A. B. CAPPELLO, otherwise known as RICO, is evident in the "prime rate overcharge cases"[14] in which courts decided against banks which falsely represented to their borrowers that their interest was the prime rate when in fact the bank's best customers got much lower rates. RICO's full panoply of hobnailed sanctions, including treble damages, attorney's fees, far-reaching injunctive writs and divestiture of interest in the affected enterprise, originally "intended to provide new weapons of unprecedented scope for an assault upon organized crime and its economic roots"[15], has been set loose against erring lending institutions.

Rule 10b-5[16] of the federal securities laws has spawned an inconsistent[17] body of case law touching on the aiding-and-abetting liability of banks for the fraudulent disclosure-related conduct of issuers of securities. A bank which knowingly continues to finance an issuer to enable the latter to stay in business and sell worthless securities to the public stands liable as an aider-abettor for the issuer's use of deceptive or manipulative devices in connection with the sale of these securities.[18]

A potential pitfall for lenders is also found in the Internal Revenue Code. Sections 3505(b) and 3505(a) provide, respectively, that the lender who supplies funds to an employer for the purpose of paying

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supra note 8, at 236-40; Hesse, *Developments in the Law of Lender Liability*, 428 PRACTICING L. INST./COM. 93 (1987).

14 In Morosani v. First National Bank of Atlanta, 703 F. 2d 1220 11th Cir. 1983), the U.S. Court of Appeals for the Eleventh District did not discount RICO liability for prime rate overcharge and remanded that question to the district court. Federal district courts have upheld similar claims in Charing Cross, Inc. v. The Riggs National Bank, Civ. Nos. 82-1116, 82-2207 (D.D.C. 1983)(memorandum opinion of Oct. 7, 1983); Mooney v. New Jersey National Bank, Civ. No. 82-3193 (D.N.J. 1983)(opinion of Mar. 22, 1983); Coastal Steel Corporation v. Chemical Bank, Civ. No. 82-1714 (D.N.J. 1982)(opinion of Oct. 27, 1982).

15 Russello v. United States, 52 U.S.L.W. 4003 (U.S., Nov. 1, 1983).

16 17 C.F.R. Sec. 240.10b-5.

17 *See* Hill v. Equitable Bank (D. Del. 1987), 655 F. Supp. 631 (where suit against lender failed because purchase of interest preceded misrepresentation); *In Re* Letterman Brothers Energy Securities Litigation (5th Cir. 1986), 799 F.2d 967 (where suit against lender did not prosper because damages were not proven); and Sterling v. Chemical Bank (S.D.N.Y. 1974), 382 F. Supp. 1146 (where suit against lender failed because there was no showing that there was a sale or purchase of securities and that the lender had control over the borrower's business).

18 Metge v. Baehler (8th Cir. 1985), 762 F.2d 621 (where it was held that the bank's act of financing a corporation which was involved in the business of buying, selling and servicing real estate contracts on low-cost homes with the knowledge that the thrift certificates sold by this corporation were worthless and, as a result, prolonged for the bank's benefit at the expense of the certificate holders the business life of the corporation, sufficed to state a cause of action holding the bank liable as an aider-abettor under rule 10b-5). *See generally* A. B. CAPPELLO, *supra* note 8, at 238-40.

the wages of the employees with actual knowledge that the employer does not intend or will not be able to pay the appropriate wage withholding tax or who in behalf of this employer directly pays the wages to the employees shall be liable for such tax.[19]

A bank which, in exchange for a loan, wangles from the borrower a commitment to provide some business or service not serving the purpose of securing repayment but tending to chill competition to the detriment of the borrower, runs afoul of section 1972 of the Bank Holding Act.[20]

Not to be overlooked is the implied covenant of good faith and fair dealing statutorily mandated under the Uniform Commercial Code's Secs. 1-201(19), 1-203, 1-208 and 2-309.[21] While expressly made applicable only to contracts for the sale of goods under Sec. 2-102, these sections have been invoked to hold an institutional lender liable for its failure to give prior notice of its refusal to extend a loan.[22]

Lender liability has also flourished under bank-specific, consumer-oriented fiats. The Equal Credit Opportunity Act,[23] in its sections 1691 *et seq.* and the interpretative Regulation B,[24] which proscribe discrimination against credit applicants based on race, color, religion, national origin, sex, marital status or age, have recently given rise to a welter of lender liability cases.[25] And so, too, has section 1601

[19] I.R.C. Secs. 3505(a) and (b) (1966).

See Grombinski, *Ascertaining the Procedural Rights of Lenders Subject to Section 3505 (b) Derivative Wage Withholding Tax Liability*, AMERICAN BAR ASSOCIATION, 1 EMERGING THEORIES OF LENDER LIABILITY 277 (1985).

[20] 12 U.S.C. Sec. 1972 (which applies the general anti-typing rules of the Sherman Anti-Trust Act, 15 U.S.C. Sec. 1 to commercial banking).

See Rae v. Union Bank (9th Cir. 1984), 725 F. 2d 478 (where liability was found for entering into a tying arragement upon a showing that the arrangement was unusual, anti-competitive and inured to the bank's benefit). *See also* Costner v. Blount National Bank of Maryville, Tennessee (6th Cir. 1978), 578 F. 2d 1192 (where liability was predicated on the bank's borrower's commercial paper and that the borrower employ a person to oversee compliance with the tying arrangement). *See generally* A. B. CAPPELLO, *supra* note 8, at 240.

[21] U.C.C. Secs. 1-201(19), 1-203, 1-208 and 2-309 (1987).

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

[23] 15 U.S.C. Secs.1691 *et seq.* (1974).

[24] Regulation B of 12 C.F.R. Sec. 202.7.

[25] *See* United States v. Landmark Financial Services, Inc. (MD. 1985) 612 F. Supp. 623 (involving cancellation of credit card by reason of the death of the holder's spouse); Ricci v. Key Bancshares of Maine, Inc. (D. Me. 4/10/87) No. 82-0249-P (involving termination of creditor-debtor relationship based on natural origin); Anderson v. United Finance Co. (9th Cir. 1982), 666 F. 2d 1274 (involving a lender's refusal to extend a loan unless the applicant's spouse co-signed it where the applicant was already qualified individually under the lender's standard).

of the Truth in Lending Act,[26] read together with the interpretative Regulation Z,[27] enacted to protect credit-consumers by mandating the disclosure of credit terms.[28]

Environmental consciousness has also carved out a niche in the growing hulk of lender liability law. Under federal laws designed to protect the environment from industrial pollution, like the Federal Comprehensive Environmental Response, Compensation and Liability Act,[29] a bank which, beyond mere financial control, acquires the "day-to-day" operational control of the borrower[30] or being the buyer at foreclosure [31] may be held liable for the costs of cleaning up hazardous and toxic pollutants found on the borrower's property.

Causes of action created by state statutes have likewise not escaped the attention of litigious borrowers. Still in the area of environmental law, a few states, exemplified by New Jersey, Massachusetts and New Hampshire, have enacted "super lien" statutes under which unpaid clean-up costs constitute a lien on toxic-laden properties superior to the lien of the lender for an unpaid loan on the same properties.[32]

State usury laws are, and have in practice been, a logical underpinning for claims against banks and commercial institutional lenders.[33] The same is true as regards state laws which hold such lenders to a certain standard of conduct *vis a vis* their customers.[34]

2. *Common Law Theories*

The common law theories of lender liability derive from basic principles of contract law and, more predominantly, the various species

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[26]15 U.S.C. Sec. 1601 (1968).

[27] Regulation Z of 12 C.F.R. Sec. 226.6(c).

[28]*See, e.g.*, Stone v. Davis (Ohio 1981), 419 N.E. 2d 1094 (where a bank's liability was anchored on its failure to inform the borrower that it was the bank's duty to obtain a mortgage insurance whenever the borrower desired it).

[29] 42 U.S.C. Secs. 9601-9657 (1980).

See Flick II & Replansky, *Liability of Banks to Their Borrowers: Pitfalls and Protections*, 103 BANKING L.J. 220, 248-50 (1986); Spiotto, *Current Trends in Lender Liability Litigation*, 304 PRACTISING L. INST./REAL 561 (1988).

[30] United States v. Mirabile, No. 84-2280 (E.D. Pa. Sept.6, 1985).

[31] United States v. Maryland Bank & Trust Co., 227 F.Supp. 504 (D.Md. 1987).

[32] A. B. CAPPELLO, *supra* note 8, at 245.

[33] *See, e.g.*, Edwins v. Lily (La. App. 1982), 422 So.2d 1217 (where a bank was held liable under Louisiana's Uniform Fiduciaries Act to a corporation in liquidation for the misappropriation of corporate funds of which the bank had actual knowledge through one of its officers).

[34] U.C.C. Secs. 1-203 and 1-208 (1987).

of tort. The tort theory of bad faith breach belongs to the latter but its antecedents are from that rather murky zone betwixt these two areas of law. Unlike the statutory theories whose number is coextensive with the willingness of government to regulate the various aspects of a banking relationship, the common law theories are limited by the finitude of the underlying doctrines of contract or tort law. Yet it is these theories which have drawn greater scholarly interest. This is not inexplicable. For one thing, the statutory theories consist mainly in straightforward rules susceptible of uniform construction and predictable application. By contrast, the common law theories, more compellingly, the tort of bad faith breach and prima facie tort, rely on standards requiring an open-textured type of analysis promotive of doctrinal divergence and unpredictability. For another, the threat seen by detractors of lender liability's unsettling effect on the stilted equilibrium between institutional lenders and their customers [35]is dispelled by the democratic character of the law-making process a statute undergoes. It is amplified when the theory is conceived by judges in the privacy of their chambers, detached from direct political accountability.

Aside from the tort of bad faith breach, there are seven other tort-based common law theories of lender liability. Duress or business coercion [36]as a restitutionary cause of action is[37] now regarded as an affirmative tort in the context of a borrower-lender relationship where the bank, without having the legal right to do so, forces its borrower to choose "between distasteful situations, i.e., bow to duress or face bankruptcy, loss of credit rating, or loss of profits from a venture."[38]

Fraud, which consists in the false representation or concealment of a material fact harmfully effected and accompanied by the offending party's scienter and the aggrieved party's reasonable reliance, [39]has proved to be the undoing of banks which give false promises of benefits to induce the conveyance of property as security, make groundless

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[35] *See* Ebke & Griffin, *supra* note 5; Borders, *The Growth of Lender Liability: An Economic Perspective*, 21 GA. L. REV. 723 (1987).

[36] There is business coercion when "one is compelled to act against his will in such manner that he suffers a serious business loss or is compelled to make a monetary payment to his detriment." 25 AM.JUR.2d *Duress and Undue Influence*, Sec. 6, nt. 15 (1966).

[37] A. B. CAPPELLO, *supra* note 8, at 182, citing, *e.g.*, Pecos Construction Co. v. Mortgage Investment Co. of El Paso (N.M. 1969), 549 P.2d 842.

[38] State National Bank of El Paso v. Farah Manufacturing Co., Inc. (Tex. App. 1984), 678 S.W.2d 661, citing 13 WILLISTON ON CONTRACTS Sec. 1617 (3d ed. 1970).

[39] Cantor, Kerr, Jr. & Rice, *Lender Liability Theories*, 434 PRACTISING L. INST./COM. 71, 73 (1987).

threats to bankrupt a borrower by declaring him in default or deceive him as to the proper construction of a loan document.[40]

Conversion, as a theory of lender liability, is any "unauthorized assumption and exercise by a lender over the borrower's right of ownership of goods or personal property which alters the condition of the property or excludes the borrower's rights."[41] Exemplary of this is the lender's wrongful repossession of, or refusal to surrender, property used as collateral for a loan.[42]

Negligence, too, has become a prolific source of lender liability.[43] That the "banking business is affected with a public interest" and that "their officers have been held to a high degree of integrity and responsiveness to their public calling" justify the "recognition of a tort duty of reasonable care" in processing loan applications.[44]

Problem loans are fraught with peril for self-protective lenders. In its desire to keep a financially troubled borrower from going belly-up and assure itself a steady stream of payments, the lender often intervenes in the latter's management and while in that position of control and dominance, commits egregious acts prejudicial to the borrower or the other creditors. Such conduct constitutes tortious interference[45] or makes the lender liable under any of the control

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40 *See* A. B. CAPPELLO, *supra* note 8, at 95-105 for an illustrative survey of relevant case law.

41 *Id.* at 207.

42 *Id.*

43 *See* A. B. CAPPELLO, *supra* note 8, at 189-206.

44 Jacques v. First National Bank of Maryland (Md. App. 1986), 515 A.2d 756.

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

theories based on a fiduciary relationship[46] and the principles of alter-ego/instrumentality,[47] agency[48] and estoppel.[49]

The lender's wrongful conduct, e.g., unjustified repossession of security[50] or unconsented release of confidential information,[51] if made public and if detrimental to the borrower, will give rise to tortious liability for defamation. The same act done intentionally or recklessly in an outrageous manner and resulting in emotional distress may amount to tortious infliction of emotional distress.[52]

An esoteric species of tort, the prima facie tort, deriving from Justice Holmes' seminal statement in *Aikens v. State of Wisconsin*[53] that "[p]rima facie, the intentional infliction of temporal damage is a cause of action, which, as a matter of substantive law whatever may be the form of pleading, requires a justification if the defendant is to escape,"[54] has also been used, though without success, the typical defense interposed by lenders being that their "valid business interest" suffices as such justification.[55]

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46 *In Re* Beverages International Ltd. (Bankr. D. Mass. 1985), 50 B.R. 273 (where the bank which had taken control of the borrower was deemed to have assumed the "fiduciary duties of management and a duty to deal fairly with other creditors").

47 Krivo Industrial Supply Co. v. National Distillers & Chemical Corporation (5th Cir. 1973), 483 F.2d 1098, modified in 490 F.2d 483 (where the lender-corporation dominated, and was held liable for the trade debts of, the borrower-corporation on the theory that a "corporation may be held liable for the debts of another corporation when it misuses that corporation by treating it, and by using it, as a mere business conduit for the purposes of the dominant corporation").

48 A. Gay Jensen Farms Co. v. Cargill, Inc. (Minn. 1981), 309 N.W.2d 285 (where the lender was held liable for the debts of the borrower on the basis that "an agency relationship was established by [the lender's] interference with the internal affairs of [the borrower] which constituted *de facto* control").

49 Dunson v. Stockton, Whatley, Davin & Co. (Fla. App. 1977), 346 So.2d 603 (where the lender which had taken complete operational control of a construction company to which it had extended a loan was held to be in estoppel to disregard the construction contract which the latter had forged with a borrower).

50 Alaska Statebank v. Fairco (Alaska 1983), 674 P.2d 288.

51 Suburban Trust Co. v. Waller (Md. App. 1979), 408 A.2d 758.

52 Sanchez-Corea v. Bank of America 38 Cal.3d 892, 215 Cal. Rptr. 679 (1985).

53 195 U.S. 194 (1904).

54 *Id.* at 204.

55 Centerre Bank of Kansas City, N.A. v. Distributors, Inc. (Mo. App. 1985), 705 S.W. 2d 42 (where the bank which induced the borrower to execute personal guarantees with false assurances that it would not declare the loan in default was held to have acted pursuant to its "valid business interest").

The common law theories have been described as "emerging".[56] In fact, most of them are traditional in the sense of being "time-honored,"[57] "old-fashioned"[58] and "well-established".[59] While not earth-shakingly novel, only the tort of bad faith breach and prima facie tort merit this description. For they are truly emerging in the sense of being "arcane or complicated,"[60] relatively untested and poised at the very "leading edge"[61] of the law of lender liability.

3. *New Wine in Old Bottles*

Because the common law theories use familiar principles as conceptual linchpins, commentators have been quick to judge them as presenting nothing new or trailblazing.[62] Less perceptible and yet more significant is the shift in ideological vision and rhetorical mode which the emergence of lender liability represents. As institutional lenders increasingly bite the dust in legal tussles with small borrowers, the waning view sanctifying contractual autonomy will in time give way to

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56 Ebke & Griffin, *supra* note 5; Kitada, *Emerging Theories of Bank Liability--The Breach of the Covenant of Good Faith and Fair Dealing*, 103 BANKING L. J. 80 (1985).

57 *"Lender Liability": The Next Big Area for Your Firm?* LAWYERS ALERT, Sept. 5, 1988, at 6.

58 *Id.*

59 Ebke & Griffin, *supra* note 5, at 782.

60 *"Lender Liability": The Next Big Area for Your Firm?*, *supra* note 57.

61 Ebke & Griffin, *supra* note 5, at 798.

62 Flick II & Replansky, *Liability of Banks to Their Borrowers: Pitfalls and Protections*, 103 BANKING L. J. 220, 257 (1986) ("The various theories of liability...are, for the most part, not new or novel theories of law. What is new is the willingness of borrowers in default on their loans or otherwise in finacial trouble to utilize these theories in an action against their banks."); Cantor, Kerr, Jr. & Rice, *Lender Liability Theories*, 434 PRACTICING L. INST./COM. 71 (1987) ("Lender liability does not denote any particular or new theory of liability. Rather, lender liability claimants seek to employ traditional legal theories in a new setting to hold lenders liable for perceived unfairness in lending relationships."); Hesse, *Developments in the Law of Lender Liability*, 428 PRACTICING L. INST./COM. 93 (1987) ("There is nothing new under the sun! Perhaps I am getting old[er], but it seems to me that some judges and attorneys are discovering concepts and theories that were familiar to Blackstone and certainly to Karl Llewellyn [principal draftsman of U.C.C. Arts. 1 and 2], Grant Gilmore and Allison Dunham [co-drafts-persons of U.C.C. Art. 9]. The point is that some so-called new developments seem to me to be a return to the fundamentals legal and equitable principles and an application of those principles to the current commercial setting. That is, of course, how it should be. New priciples of liability are and ought to be hard to come by."); A. B. CAPPELLO, *supra* note 8, at xvii ("It is a popular misconception that lender liability is a new area of law. No doubt customers have been suing their banks for breaches of contract, statutory violations, and torts for as long as banks have existed. However, what is new is the greater frequency with which borrowers are recovering against their lenders, the size of the awards when they do recover, and the increase in lawsuits being filed by borrowers.").

judicial paternalism and judicial facilitation.[63] This change in juristic predisposition is truly phenomenal.[64] Yet it is only a skirmish in the larger struggle between individualism, which argues that unrestricted self-interest and self-reliance inure to the benefit of society, and altruism, which views sharing and sacrifice as promotive of the public good.[65] Because nothing akin to it has hitherto been seen in the area of creditor-debtor law, lender liability is to that extent new, nay iconoclastic. Judicial rationalization of this shift may have so far bottomed on old and traditional modalities, like new wine poured into old bottles. But such fact alone cannot diminish its novelty in the larger sense noted.

II. THE ENVIRONMENTAL MATRIX OF LENDER LIABILITY

A. The American Context

Lender liability is essentially the resort to the general compensation system as a means to mitigate the harshness occasioned by the regime of economic *laissez faire* prevailing in the lending industry.[66] Given the unprecedented proliferation of problem loans and loan workouts,[67] as well as the opportunity presented by resulting litigation to resolve the conflict between two economic constituencies, the institutional lenders on the one hand and their customers on the other, courts are favoring the latter in a way that a providential force might expectedly intervene in a whale-minnow type of conflict. The rise in the number of problem loans has been ascribed to the "substantial deterioration in the quality of loan portfolios."[68] "[I]ncreased competition between and among commercial lenders...has created an

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63 Borders, *The Growth of Lender Liability: An Economic Perspective*, 21 GA. L. REV. 723, 726 (1987); *see* Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685, 1735, 1736 (1976).

64 Borders, *The Growth of Lender Liability: An Economic Perspective*, 21 GA. L. REV. 723, 726 (1987).

65 Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV 1685 (1976).

66 Ebke & Griffin, *supra* note 5, at 805.

67 A workout "is an arrangement in which new terms for payment are negotiated, either on a reduced or slower payment schedule. Workouts are usually in the best interests of both the borrower and lender since they enable the borrower to continue operating, which in turn increases the probability that the loan will be repaid.... One particularly troubling problem that can arise during a workout occurs when the lender takes control of the borrower. This usually occurs when the lender tries to help the borrower 'get back on its feet,' hoping that 'help' will be temporary and will resolve the problem. If the lender at that point actually takes control of the borrower's business, it may find itself liable under any of the various control theories." A. B. CAPPELLO, *supra* note 8, at 75.

68 Ebke & Griffin, *supra* note 5, at 804.

environment in which financial institutions seem more and more inclined to pursue aggressive and expansionary growth programs in the course of which safe and sound practices seem to be sacrificed in favor of rapid growth and expansion."[69] Unbridled competition led to improvidence in evaluating lending risks which, in turn, resulted in a plethora of bad loans.

Before the late 1960s, the rather storied history of the lending industry made for a patchwork regulatory scheme. Long periods of calm sporadically broken by "specific economic or financial shocks, such as the financial panics of the early 1900s and the widespread bank failures occuring during the Great Depression,"[70] "precipitated major legislative or regulatory responses."[71] Three policy objectives were eventually adopted to sustain an enduring regime of governmental protectionism suppressive of free-wheeling competition. The first called for the "preservation of institutional insolvency," the second for the maintenance of "limits on the concentration of power" and the third for "increased availability of services, especially credit."[72]

The first objective sought to avert systemically catastrophic bank failures by making banks risk-averse. Limitations were imposed on such balance sheet components as liquidity, loan size and capital.[73] Also, financial institutions were restricted to separate product markets; commercial banks were limited to fractionated geographic markets; and interest rates for deposits were statutorily limited to ensure solvency through the maintenace of a substantial regulatory spread.[74] Finally, "institutional safety-nets,"[75] like the Federal Deposit Insurance and the Federal Reserve System, were established to "alleviate the secondary effects of [bank] failures that did occur."[76]

The second objective grew out of the "public's distrust of concentrated banking power,"[77] which expressed itself in restricted branching, separation of the investment banking and commercial

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69 *Id.* at 806.

70 CRANE, KIMBALL & GREGOR, THE EFFECTS OF BANKING REGULATION 11 (1983).

71 *Id.*

72 *Id.*

73 *Id.*

74 *Id.* at 14.

75 *Id.* at 17.

76 *Id.*

77 *Id.* at 17.

banking functions,[78] and with respect to the more recent phenomenon of corporate takeovers, the strict application of anti-trust standards.[79]

The third objective led to the establishment of special-purpose institutions, like the savings and loan associations, the various banks of the Farm Credit System, the Federal Home Loan Bank System and the National Consumer Cooperative Bank,[80] as well as the legislative proscription of discrimination embodied in such fiats as the Equal Credit Opportunity Act of 1974 and the Community Reinvestment Act of 1977.[81]

By the 1970s, the "economy became increasingly unsettled and existing rules had already begun to inhibit banks from responding appropriately to market forces."[82] Inflation, the first systemic trauma, induced increased volatility of deposit interest rates, resulting in the rise of these rates well beyond the ceilings set for the rates which banks must pay on time deposits.[83] This drove away depositors who turned to instruments that paid market-determined rates. To "stem the hemorrhage of consumer deposits out of the banking system,"[84] interest rates on time deposits were deregulated and new liability products dependent on market rates of return were introduced.[85] Aggressive competition among banks, the likes of which had not been seen before, followed.[86]

Aside from inflation, the 1970s also felt the pressure of computer technology on the highly regulated banking and financial system. The widespread use of computerized delivery mechanisms, like the cash management systems and the automated teller machines, "began to break down geographic markets and provide alternatives to the traditional brick-and-mortar branch."[87]

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[78] *Id.* at 19.

[79] *Id.* at 17.

[80] *Id.* at 20-23.

[81] *Id.* at 23.

[82] Wynne & Spagnola, *The Myth of Bank Deregulation: For Every Action There is an Equal and Opposite Reaction*, 42 WASH. & LEE L. REV. 383, 387 (1985).

[83] CRANE, *supra* note 70, at 26.

[84] Loring & Brundy, *The Deregulation of Banks*, 42 WASH. & LEE L. REV. 347, 349 (1985).

[85] Deregulation was effected by the Garn-St. Germain Depositary Institutions Act of 1982, Pub. L. No. 97-320, October 15, 1982, 96 Stat. 1469. *See* Loring & Bundy, *supra* note 84, at 352.

[86] CRANE, *supra* note 70, at 28.

[87] *Id.* at 30.

Lastly, during the same period, the growing sophistication of credit consumers as manifested in the large corporation's increasing use of commercial paper in lieu of idle deposits, the consumer's utilization of open-market financing alternatives and their gravitation to non-bank competitors, further whetted competition among the lending institutions.[88]

By the start of the 1980s, these developments had transmogrified the banking and financial industry. "Traditional distinctions among financial institutions had become blurred as their product lines were expanded"; "[f]inancial markets that had once been very localized were becoming more national in scope"; "[b]anking services were being unbundled as the delivery functions were separated from the production of services."[89] In the heat of the resulting competition, banks seeking to diversify and expand their loan portfolios threw discretion to the wind and reaped a whirlwind of problem loans. Economic recession led to defaults which sparked litigation. In a society teeming with lawyers,[90] defaulting or floundering borrowers saw no shortage of crusading advocates willing to lock horns with institutional lenders. Add to this the recent merger- and takeover-mania to which the banking industry has not been immunized. "As banks become part of larger organizations, they can lose the personal feeling they had with borrowers.... As banks get away from the close contact with borrowers, borrowers don't feel so queasy about suing."[91] Courts, steeped in the "increasing recognition of the law's role in correcting inequitable or unequal exchanges between parties of disproportionate bargaining power"[92] and riding on the momentum of an "explosion of liability,"[93] saw in many of the cases involving institutional lenders and their customers the tell-tale attributes of an unfair fight transcending mere overreaching. Literalism seemed to wooden an argument against judicial intervention where unbending fealty to the language of contracts militated against basic notions of fairness and equity. Associating villainy with bigness, courts have made and are making institutional lenders pay, and dearly, by favoring borrowers with whopping awards in damages. The feverish search for theories rationalizing these awards has yielded a cornucopia of lender liability case law.

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88 *Id.* at 30-31.

89 *Id.* at 34.

90 655,191 lawyers as of 1985. *See* B. CURRAN, K. ROSICH, C. CARSON & M. PUCCETTI, SUPPLEMENT TO THE LAWYERS STATISTICAL REPORT: THE U. S. LEGAL PROFESSION IN 1985 (1985).

91 Cochio & Clark, *Lenders, better watch your backs*, A. B. A. BANKING J., (Nov. 1986), at 32, 33.

92 Totem Marine Tug & Barge, Inc. v. Alyeske Pipeline Service, Inc. (Alaska 1978) 584 P.2d 15, 21.

93 G. GILMORE, THE DEATH OF CONTRACT 65 (1974).

B. The Philippine Setting

The Philippines' credit-based, capitalist economy. features a financial system that has over the years gone through varying regimes of governmental regulation. In ways approximating the dynamics of its American counterpart, the Philippines' financial system has been wracked by changes during the past thirty years along the familiar path to deregulation. Environmental trauma exerted systemic pressures on the system, entailing the abrogation of legislative controls and the unbundling of competitive market forces, albeit not to the same extent nor with the same intensity peculiar to the more frenetic market arena in the American setting.

A regime of "rigid and low interest rates"[94] lasted from 1956, when the Central Bank began to regulate the deposit rates of banks, up to 1973. During this period, an anti-usury law[95] effective since 1916 kept interest rates[96] on savings and time deposits at bay to ensure that banks, given the ceilings[97] on lending rates, enjoyed wide margins on the loans they extended from the accumulated savings of depositors. This state of affairs "encouraged the operation of inefficient banks,...hampered the allocation of financial resources"[98] and by promoting a "bias in favor of borrowings to finance investment instead of leading the business sector to raise funds in the equity market,"[99] retarded the growth of the stock market[100] and non-bank financial intermediaries.[101]

In 1970 a "flood of excess liquidity"[102] resulting from the government's heavy deficit spending[103] compelled the adoption of a floating rate policy[104] for the Philippine peso which, in turn, led to the

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94 Laya, *Floating Interest Rates in the Eighties: A New Dimension in the Philippine Financial System*, (1982) THE FOOKIEN TIMES 1981-82 PHILIPPINE YEARBOOK 146, 147.

95 Act No. 2655 (1916).

96 In 1956 Central Bank Circular No. 67 prescribed an interest rate of 2 percentum on saving and time deposits. A subsequent succession of circulars upwardly revised this rate. In 1974 Central Bank Circular No. 414 raised the rate to 6 percentum for savings deposits and 8 percentum for time deposits. *See* Table 1 in Laya, *supra* note 94, at 146.

97 The Usury Law of 1916 imposed a maximum lending rate of 12 percentum for guaranteed loans and 14 percentum for non-guaranteed loans.

98 Laya, *supra* note 94, at 147.

99 *Id.* at 148.

100 *Id.*

101 *Id.*

102 1970 CENTRAL BANK OF THE PHILIPPINES TWENTY-SECOND ANNUAL REPORT 3.

103 *Id.*

104 G. SICAT, NEW ECONOMIC DIRECTIONS IN THE PHILIPPINES 189 (1974).

latter's more than 60 percentum devaluation.[105] These developments compounded the adverse effects of the rigid interest rate policy. In response, a modulated interest rate policy was adopted, establishing a regulatory regime lasting from 1974 to 1980. During this period, the strictures of the Usury Law of 1916 underwent steady attenuation as the maximum lending rates were progressively raised, on occasion suspended and ultimately abolished.[106] The new policy was the bruited solution to the "distorting"[107] influence of inflexible interest rates, as well as the proffered "monetary tool for redirecting resources and containing inflation."[108]

Though not solely attributable to the modulated interest rate policy, the Philippines' over-all liquidity position increased in 1973 by 43 percentum.[109] Credits granted by commercial banks, rural banks and savings and loan associations increased, respectively, by 43 percentum, 38 percentum and 37 percentum.[110] Such lending was absorbed largely by the private sector.[111] In 1978 increasing liquidity "spurred competition among financial intermediaries resulting at that time in declining lending rates and easier access to credit. In their desire to maintain credit growth, banks began to enter markets...traditionally considered risky, among these, the unsecured commercial paper market and foreign exchange dominated (*sic*) loans."[112]

In 1981 the regime of modulated deregulation gave way to a new policy of floating interest rates. Government allowed interest rates "to equilibrate at a point where the supply for funds [was] met by an equal demand for funds"[113] according to the dynamics of a free market. This was deemed necessary to enable the modified universal banking system to "truly foster greater competition among [financial institutions] and

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105 BELLO, KINLEY & ELINSON, DEVELOPMENT DEBACLE: THE WORLD BANK IN THE PHILIPPINES 22 (1982).

106 On January 29, 1973 Presidential Decree No. 116 was issued giving the Central Bank the general authority to prescribe and change the maximum interest rates "for loan or forbearance of money, goods or credits, whenever warranted by prevailing economic and social conditions but not more often than once every twelve months." On December 31, 1975 Presidential Decree No. 858 was issued granting the Central Bank the power to "eliminate, exempt from, or suspend the effectivity of interest rate ceilings on certain types of loan or forbearance."

107 G. SICAT, *supra* at note 104, at 196.

108 *Id.* at 197.

109 1973 CENTRAL BANK OF THE PHILIPPINES TWENTY-FIFTH ANNUAL REPORT 5.

110 *Id.* at 111-15.

111 *Id.* at 111, 112.

112 Estanislao, *Commercial Banking in the Philippines*, (1984) THE FOOKIEN TIMES 1983-84 PHILIPPINE YEARBOOK 166.

113 Laya, *supra*, note 94, at 149.

eventually lead to more efficient operations"[114] by calling for less differentiation among them. Floating the interest rates increased savings, time deposits and deposit substitutes.[115] Though precipitated by an interplay of factors and thus not exclusively ascribable to the same sort of surging competition which in the American context had spawned the plethora of bad loan portfolios, the next two years--1983 being the nadir--would yield a string of business failures and corporate bankruptcies.[116] Periodic credit surveys during this period, while revealing a rather inconclusive pattern respecting the number of problem loans and suits for sums of money, estafa (criminal conversion) and replevin occuring in 1980, show an "alarming trend" for the second quarter of 1981.[117]

Indubitable as this flood of credit-related litigation may be in suggesting a propensity on the part of lenders to sue defaulting borrowers, it is less so in prefiguring a tendency on the part of these borrowers to resist or counter-sue with the same contentiousness and creativity that contributed to the rise of lender liability in the United States. On the other hand, the current dearth of lender liability judgments hardly negates the starting proposition that lender liability is as viable in the Philippine context as it has been in the jurisdictions where it evolved. It may well be that in contrast to the more dynamic character of American judicial law-making, new concepts of liability go through a longer gestation period in the Philippines on account of the glacial pace of episodal trials, the administrative gridlock caused by clogged dockets and judicial hesitance, borne of the civil law elements of the latter's hybridized legal system, to make law even where such is proper. Only time will tell if the record volume of credit-related litigation observed will fructify into a body of judicial holdings analogous to the theories of lender liability in the United States. Indeed, there is nothing to indicate that lender liability principles are wholly alien to, and therefore incongruent and unintegrable with, the

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114 *Id.*

115 1981 CENTRAL BANK OF THE PHILIPPINES TWENTY-THIRD ANNUAL REPORT 2.

116 *Financial System "Out of danger" after rescue & rehabilitation*, BUS. J. Sept. 1981 (Vol. LVII, No. 9), at 2; *Economic Prospects: Mix of "streaks of sunlight" and "dark clouds" for R.P.*, BUS. J., April 1983 (Vol. LIX, No. 4), at 2-4.

117 *See Business Month [under the item on Credit]*, BUS. J., May 1981 [Vol. LVII, No. 5], at 26, 30 in relation to *Business Month [under the item on Credit]*, BUS. J., June 1981 [Vol.LVII, No. 6], at 30, 31; *Business Month [under the item on Credit]*, BUS. J., Aug. 1981 [Vol. LVII, No. 8], at 28, 32; and *Business Month [under the item on Credit]*, BUS. J., Oct. 1981 [Vol. LVII, No. 10], at 58, 61; in contrast to *Business Month [under the item on Credit]*, BUS. J., May 1980 [Vol. LV, No. 5], at 28, 30; *Business Month [under the item on Credit]*, BUS. J., June 1980 [Vol. LV, No. 6], at 28, 30; and *Business Month [under the item on Credit]*, BUS. J., July 1980 [Vol. LV, No. 7], at 34, 36.

Philippine legal order. It can be broached with confidence that the Philippine legal system does offer a viable matrix for the emergence of lender liability law and that, in particular, the tort of bad faith breach as a theory of lender liability is applicable in the Philippine context.

III. THE TORT OF BAD FAITH BREACH AS AN EMERGING COMMON LAW THEORY OF LENDER LIABILITY

A. The Uncertain Beginnings of The Tort of Bad Faith Breach

The duty of good faith in the transactional context flows from three possible sources, namely, the common law contract theory, the Uniform Commercial Code and the common law tort theory.[118] While the first two are recognized as "general principles of law,"[119] the third, representing as it does an extra-contractual extension of the common law contract theory of the implied covenant of good faith and fair dealing, remains trapped in legal cross-currents and roiled by controversy. Beyond the narrow province of insurance-related transactions in which it first drew attention as a judicial tool for adjudicating conflict, its applicability to other transactions has been stymied by "judicial hesitance"[120] "dearth of analysis"[121] and outright hostility from traditionalists who take the view that it "represents an ill-advised solution to the problems of undercompensation and bad faith conduct in the performance and termination of contracts."[122] Its recent adoption by litigious borrowers to complement their legal arsenal against institutional lenders has only made it more controversial.

Literalism in traditional contract law coincided with, and reinforced, a regime of judicial neutrality that accorded primacy to the aphorism that "courts do not make a contract for the parties."[123] Immersed in this formalistic tradition, seventeenth century Anglo-American common law courts handled contracts with utmost timidity, regarding them as the exclusive framework of what the parties had

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118 *See* Cantor, Kerr, Jr. & Rice *supra*, note 39, at 434.

119 Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L REV. 369, 369 (1980).

120 Diamond, *The Tort of Bad Faith Breach of Contract: When, If at All, Should It Be Extended Beyond Insurance Transactions*, 64 MARQ. L. REV. 425, 429 (1981).

121 *Id.*

122 Chutorian, *Tort Remedies For Breach of Contract: The Expansion of Tortious Breach of the Implied Covenant of Good Faith and Fair Dealing Into The Commercial Realm*, 86 COL. L. REV. 377, 377 (1986).

123 3 A. CORBIN, CORBIN ON CONTRACTS 94 (1960), citing Temple v. Clinton Trust Co., 62 A. 2d 690, 1 N.J. 219 (1948).

consented to--defects, omissions and all.[124] In this wild Darwinian setting, such rules as *Caveat emptor* held sway.[125] This regime, however, did not in its pristine state last. Eventually, "in order to prevent the disappointment of expectations that the transaction aroused in one party, as the other had reason to know, the courts [began to] find and enforce promises that were not put into words, by interpretation when they can and by implication and construction when they must."[126] With increasing self-assurance, courts began to flesh out this framework, where the agreement could not be established, by the "imaginative projection of the expressed purpose upon situations arising later, for which the parties did not provide and which they did not have in mind."[127] In the twentieth century, all pretensions about the untouchability of the written agreement were ejected. Judicial divination on the basis of what the parties "intended" was superseded by resort to fictions of implied terms.[128] One of these is the implied covenant of good faith and fair dealing.

The seminal case is *Kirke La Shelle Co. v. Paul Armstrong Co.*,[129] decided in 1933 by the New York Court of Appeals, in which the implied duty of good faith and fair dealing was defined, to wit:

> In every contract there is an implied covenant that neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract, which means that in every contract there exists an implied covenant of good faith and fair dealing.[130]

Kirke La Shelle's progeny were legion[131] but none of the judicially formulated standards of bad faith sufficed since they "directed attention to the amorphous totality of the factual circumstances at the time of formation, and fail to distinguish relevant from irrelevant facts within the realm."[132] Deriving from the notion,

124 Farnsworth, *Disputes Over Omission in Contracts*, 68 COLUM. L. REV. 860, 862-64 (1968).

125 *Id.* at 863.

126 *Id.* at 97.

127 Justice Learned Hand's dissenting opinion, L. N. Jackson & Co. v. Royal Norwegian Government, 177 F. 2d 694, 702 (2d Cir. 1949), *cert. denied*, 339 U. S. 914 (1950).

128 Farnsworth, *supra* note 124, at 865-66.

129 263 N.Y. 79 (1933).

130 *Id.* at 87.

131 *See* Burton, *supra* note 119.

132 *Id.* (Burton advances in this article an operational standard of good faith performance based on a cost perspective analysis which takes into account, as a

drawn with broad-brush generality, that parties to a contract have a duty to abstain from what will interfere with either's right to the benefits thereof, these standards were nothing more than conceptual adumbrations. Later attempts at explication were by way of illustrative enumeration. The Restatement of the Law (Second) Contracts of 1973 dichotomized the implied covenant according to two stages of the contract process.[133] The first, good faith performance, covers such violations as "subterfuges and evasions,"[134] "evasions of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of a power to specify terms, and interference with or failure to cooperate in the other party's performance."[135] The second, good faith enforcement, refers to such violations as "conjuring up a pretended dispute, asserting an interpretation contrary to one's own understanding, falsification of facts,...harassing demands for assurances of performance, rejection of performance for unstated reasons, willful failure to mitigate damages and abuse of a power to determine compliance or to terminate the contract."[136]

Described by one commentator as exemplary of the reabsorption of contract law into tort law,[137] bad faith breach subsequently acquired a dual mold, one as contractual breach and the other as tort. Accordingly, non-compliance with the implied covenant of good faith and fair dealing in certain limited areas of economic and commercial endeavors became an independent species of tort entitling the aggrieved party to certain types of damages not available under the contract theory, e.g., damages for mental suffering, economic losses not foreseeable at the time the contract is made, and punitive damages.[138] "The underlying rationale for [this] development...is the inadequacy of damages in a contract action."[139] Logically, its twin objectives are the "imposing of a greater measure of damages in contract actions and of punishing and thereby deterring some types of [contractual] breach."[140] While augmenting recovery under a new legal climate that eschewed economic individualism and enhanced judicial sensitivity to the abuses of

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component of the contractual expectation interest, the opportunities which the promissor foregoes at the time of contract formation.).

133 RESTATEMENT OF THE LAW (SECONS) CONTRACTS Sec. 231, p. 521 (1973).

134 *Id.* at 522.

135 *Id.* at 524.

136 *Id.*

137 *See* G. GILMORE, *supra* note 93, at 83..

138 *See* Diamond, *supra* note 120, at 426-27; Monaghan, *Extending the Bad Faith Doctrine to General Commercial Contracts*, 65 B.U. L. REV. 355 (1985).

139 Myers, *Bad Faith: A Tort Expands to Protect the Insured*, 18 TRIAL 56, 56 (1982).

140 Chutorian, *supra* note 122, at 380.

superior bargaining power characterizing unconscionable contracts,[141] the tort of bad faith breach offended traditionalists insisting on bright-line distinctions between contract and tort,[142] as well as those who, singling out the matter of punitive damages, espied the threat it posed to commercial transactions the free and unhampered flow of which was supposedly desirable because "a contract breaker rarely stands to lose as much by his breach as he would by performance [and] the more deliberate the breach, the more apt he is to gain."[143]

B. California: The Special Relationship Rule

1. The Insurance Context

The tort of bad faith breach first saw light in California as a new cause of action arising from the breach of insurance contracts in the third party insurance context. *Comunale v. Traders & General Insurance Co.*,[144] is the first case to recognize the tort of bad faith breach on the basis of the implied covenant of good faith and fair dealing. There the third party sued the insured for personal injury after being compelled to go to trial by the insurer's rejection of the third party's $4,000 settlement offer. The third party obtained a judgment against the insured in the total amount of $26,000 and the insurer paid only that portion of this judgment covered by the insurance policy, thus leaving the insured the balance of $15,000. The California Supreme Court held that the insurer's rejection of the settlement offer violated its implied duty of good faith and fair dealing and constituted a tort warranting the award in favor of the insured of such damages as would allow him to recover the judgment against him "even if it exceeds the policy limits."[145]

Nine years later, the same tribunal iterated the *Comunale* rule in *Crisci v. Security Insurance Co.*,[146] a case involving a similar factual situation. Damages for mental distress, hitherto unthinkable for breach of contract,[147] were awarded to underscore the tortious nature of the

141 Borders, *supra* note *, at 726-32.

142 *See* Monaghan, *Extending the Bad Faith Doctrine to General Commercial Contracts*, 65 B. U. L. REV. 355, 373 (1985); Snow, *Excess Liability- Crisci and Lysick*, 36 INS. COUNSEL L. J. 51, 54 (1969).

143 Mueller, *Contract Remedies, Business Fact and Legal Fancy*, 1967 WIS. L. REV. 833, 835 (1967).

144 50 Cal.2d 770, 328 P.2d 198 (1958).

145 *Id.* 50 Cal.2d at 661, 328 P.2d at 202.

146 66 Cal.2d 425, 58 Cal. Rptr. 13, 426 P.2d 173 (1967).

147 *See, e.g.*, Bolden v. John Hancock Mutual Life Insurance Co., (E.D. Mich. 1976), 422 F.Supp. 28.

insurer's misconduct. The Court explained the underlying public policy thus:

> Fundamental in our jurisprudence is the principle that for every wrong there is a remedy and that an injured party should be compensated for all damages proximately caused by the wrongdoer. Although we recognize exceptions from these fundamental principles, no departure should be sanctioned unless there is a strong necessity therefore.[148]

Six years after *Crisci,* the California Supreme Court in *Gruenberg v. Aetna Insurance Co.,*[149] held that the implied covenant of good faith and fair dealing was non-consensual, implied as it was by law, and as such imposed an obligation the breach of which gave rise to a tort independent of an action for breach of contract. This ruling, notes one commentator, comports with the view expressed by Prosser and Keeton to the effect that "[tort] obligations are in general obligations that are imposed by law on policy considerations...apart from and independent of promises made and therefore apart from any manifested intention of parties to a contract or other bargaining transaction."[150]

The common theme threading through the reasoning in the cited cases and in the long line that followed them, notably *Egan v. Mutual of Omaha Insurance Co.,*[151] is the "adhesive nature"[152] of an insurance contract and the "inherently unbalanced"[153] bargaining positions of the insurer and the insured relative to one another. The overriding concern consists in the insurer giving "'at least as much' consideration to the interests of the insured as it accords to its own interests."[154] For well over a quarter of a century after *Comunale,* the tort of bad faith breach was limited to the insurance context. Three arguments of varying plausibility were adduced in *Iron Mountain Security Storage v. American Specialty Foods, Inc.*[155] to explain this. First, the special fiduciary character of insurance contracts was thought to separate them from other contracts.[156] The existence of a fiduciary obligation not being an essential element of the tort as defined by precedents, this

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148 66 Cal.2d 425, 433 (1967).

149 9 Cal.3d 566, 108 Cal. Rptr. 480, 510 P.2d 1032 (1973).

150 W. KEETON, D. DOBBS, R. KEETON & D. OWENS, PROSSER AND KEETON ON THE LAW OF TORTS 656 (1984), quoted in Monaghan, *Extending the Bad Faith Doctrine to General Commercial Contracts,* 65 B. U. L. REV. 355, 360 nt. 39 (1985).

151 24 Cal.3d 809, 620 P.2d 141, 169 Cal. Rptr. 691 (1979).

152 *Id.* 24 Cal.3d at 819, 620 P.2d at 145, 169 Cal. Rptr. at 696.

153 *Id.*

154 Chutorian, *supra* note 122, at 383, citing *id.*

155 (E.D. Pa. 1978), 457 F.Supp. 1158.

156 *Id.* at 1166-69.

argument seems tenuous.[157] Second, insurance contracts deserved to be singled out because of their adhesive nature.[158] This argument ignores the ubiquitousness of adhesion contracts in many noninsurance commercial contexts.[159] Third, since virtually all contractual breaches involve a breach of faith,[160] extending the tort to all contractual breaches would aggrandize it. This argument fails to explain why a wrong, no matter how common, should not warrant liability in tort.[161]

One commentator advanced the more plausible theory that the judicial reluctance to apply the tort to other types of contracts--

> reflects a perceived awareness of, and faithfulness to, one of the most poorly kept secrets in legal history: Bad faith breach of contract, if defined as an intentional breach motivated by crass economic self-interest, has been, despite a clamoring of moral credos to the contrary, a judicially accepted staple of our system of commercial law. While some have condemned the wilfull contract breaker as a repulsive, evil aberration, woefully disrupting moral quietude, a close scrutiny of commercial law doctrine, and the briefest scrutiny of commercial practice, makes it transparently clear that our system not only sanctions bad faith breaches, but, with limitations, actually encourages them.[162]

This theory, however, succumbs to the same criticism leveled at the rationales proffered in *Iron Mountain*, i.e., singling out insurance contracts when these rationales apply with equal validity to other commercial transactions is to indulge in specious logic.

2. The Noninsurance Context: To theBrink and Then a Few Steps Back

A skein of rulings starting with the 1980 cases of *Tameny v. Atlantic Richfield Co.*[163] and *Cleary v. Life of Montana Insurance Co.*[164] gingerly challenged the exclusivity of the tort of bad faith breach to insurance transactions. These cases intimated that the unlawful dismissal of an employee, though not squarely constitutive of the tort of bad faith breach, gave rise nonetheless to a tort liability considering

157 Diamond, *supra* note 120, at 430.
158 457 F.Supp. 1158, 1158 (1978).
159 *Id.* at 432.
160 457 F.Supp. 1158, 1165 (1978).
161 Diamond, *supra* note 120, at 432.
162 *Id.* at 433.
163 27 Cal.3d 167, 164 Cal. Rptr. 839, 610 P.2d 1330 (1980).
164 111 Cal. App.3d 443, 168 Cal. Rptr. 722 (1980).

that some of the features of insurance contracts are evident as well in employment contracts. This view was enough, as it were, to break the proverbial camel's back. In 1984 the Supreme Court of California in the landmark case of *Seaman's Direct Buying Service v. Standard Oil Co.*,[165] was confronted with the issue of whether one may "recover in tort for breach of an implied covenant of good faith and fair dealing in a non-insurance, commercial contract."[166] The plaintiff, a ship supply trader, sued the defendant, an oil supplier, when the latter adopted a "stonewall," "see you in court" stance by denying the existence of a binding oil dealership agreement it had previously entered into with the former. The jury found for the plaintiff and awarded it, *inter alia*, compensatory and punitive damages for intentional interference with an advantageous business relationship and tortious breach of the implied covenant of good faith and fair dealing. On appeal, the Supreme Court of California reversed the judgment with respect to the counts grounded on tort. The Court, speaking through the majority, skirted the issue of whether the tort of bad faith doctrine applied to noninsurance, commercial transactions by holding that it was "unnecessary to decide"[167] this issue or "to predicate [the defendant's] liability on a breach of the implied covenant,"[168] it being "sufficient to recognize that a party to a contract may incur tort remedies where, in addition to breaching the contract, it seeks to shield itself from liability by denying, in bad faith and without probable cause, that the contract exists."[169] The Court explained that "[t]here is little difference, in principle, between a contracting party obtaining excess payment in such manner, and a contracting party seeking to avoid all liability on a meritorious contract claim by adopting a 'stonewall' position ('see you in court') without probable cause and with no belief in the existence of a defense . . . It offends accepted notions of business ethics. Acceptance of tort remedies in such situation is not likely to intrude upon the bargaining relationship or upset reasonable expectations of the contracting parties."[170] The Court, however, nullified this finding of tort liability because of an improper jury instruction.

Despite its seeming alacrity in fashioning a new tort, consisting in the act of stonewalling or the bad faith denial of the existence of a contract, the majority was not prepared to accept the plaintiff's radical proposition that every breach of the covenant of good faith and fair dealing amounted to a tort even in the noninsurance, commercial context.

165 36 Cal.3d 752, 206 Cal. Rptr. 354, 686 P.2d 1158 (1984).
166 *Id.* 36 Cal.3d at 758.
167 *Id.* 36 Cal.3d at 769.
168 *Id.*
169 *Id.*
170 *Id.*

In this regard, the Court warned that "it [was] wise to proceed with caution."[171]

> When we move from such special relationships [referring to the special relationship between the insurer and the insured in the context of the fact-law paradigms drawn in *Comunale* and its progeny] to consideration of the tort remedy in the context of the ordinary commercial contract, we move into largely unchartered and potentially dangerous waters. Here, parties of roughly equal bargaining power are free to shape the contours of their agreement and to include provisions for attorney's fees and liquidated damages in the event of breach. They may not be permitted to disclaim the covenant of good faith but they are free, within reasonable limits at least, to agree upon the standards by which application of the covenant is to be measured. In such contracts, it may be difficult to distinguish between breach of the covenant and breach of contract, and there is the risk that interjecting tort remedies will intrude upon the expectation of the parties.[172]

Chief Justice Bird's lone dissent is more than just supererogatory. Relying on the *Tameny* and *Cleary* doctrines, she argued that the tort of bad faith breach was relevant in the commercial context regardless of the absence of a special relationship between the parties. She also formulated a two-step-test that prescinded from prerequisites of public interest, adhesion and fiduciary responsibility as enunciated by the *Egan* court. The first step is to consider the "parties' `reasonable expectations' concerning the nature of their agreement and their rights and responsibilities thereunder."[173] The second step is to determine whether the parties acted "`reasonably' in light of those expectations."[174] Next, Chief Justice Bird argued that although insurance contracts create special relationships, possessed as they were of certain attributes absent from ordinary commercial contracts, the "requirements of good faith" inherent in the former, though "probably less stringent in a commercial context,...*definitely exist.*"[175] Moreover, common to all contracts is the "expectation that a breaching party will compensate the other party for losses caused by the breaching party's failure to perform."[176] At this juncture, Chief Justice Bird alluded to Posner's view that "it is not the policy of the law to compel adherence to contracts, but only to require each party to choose between performing in accordance with the contract and compensating the other party for

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171 *Id.*
172 *Id.*
173 *Id.* at 776.
174 *Id.*
175 *Id.* at 777.
176 *Id.* at 777-78.

injury resulting from failure to perform. This view contains an important economic insight. In many cases it is uneconomical to induce the completion of the contract after it has been breached."[177] Thus, it is when the breaching party denies in bad faith that he had entered into a contract only "to shield itself entirely from liability for contract damages," that the implied covenant of good faith and fair dealing is violated.[178] Also, where the defendant repeatedly assures the plaintiff of the existence of a binding commitment and his willingness to abide by it, the possibility that the contract would be breached is taken out of the zone of the parties' reasonable expectations.[179]

Doctrinal confusion came in the wake of *Seaman's*. In 1985 the California appellate court in *Commercial Cotton Co. v. United California Bank*[180] was presented with a depositor's grievance against a bank which, after negligently debiting the depositor's account on a check with unauthorized signatures, tried to stonewall the depositor's efforts to recover from it the debited amount by interposing spurious defenses. In ordering the bank to pay punitive damages for tortious bad faith breach, the appellate court stated that such tort applied to noninsurance transactions in which the special relationship inherent in insurance contracts was likewise present. Heeding the *Seaman's* court's cautionary dictum that a blanket application of the *Comunale* ruling to every other kind of commercial contract would be unjustifiable, the appellate court plucked out banking from the generality of commercial endeavors and placed it in the same category as insurance.

> Analogyzing to the factors set out in *Egan* we agree...that *banking and insurance have much in common, both being highly regulated industries performing vital public services substantially affecting the public welfare. A depositor in a non-interest bearing checking account, except for state or federal regulatory oversight, is fatally dependent on the banking institution to which it entrusts deposited funds on the bank's honesty and expertise to protect them.* While banks do provide services for the depositor by way of monitoring deposits and withdrawals, they do so for the very commercial purpose of making money by using the deposited funds. The depositor allows the bank to use those funds in exchange for the convenience of not having to conduct transactions in cash and the concomitant security in having the bank safeguard them. *The relationship of bank to depositor is at least quasi-fiduciary*, and depositors reasonably expect a bank not to claim nonexistent legal

177 *Id.* at 778, citing and quoting POSNER, ECONOMIC ANALYSIS OF LAW 55 (1972).
178 *Id.* at 778.
179 *Id.* at 780.
180 163 Cal. App.3d 511, 209 Cal. Rptr. 551 (1985).

> defenses to avoid reimbursement when the bank negligently disburses the entrusted funds."[181][Emphasis supplied].

The *Commercial Cotton* ruling provoked adverse commentary. Notably, another division of the same California appellate court[182] would later remark that it was wholly unnecessary for the court in *Commercial Cotton* to infer that a special relationship existed in a contract between a bank and a depositor since the defendant therein was found liable for punitive damages because of its bad faith denial of all liability to the plaintiff, which, like stonewalling or the bad faith denial of the existence of a contract involved in *Seaman's*, was a tort in itself. Such a reading would denigrate to the status of an *obiter dictum* the statement in *Commercial Cotton* that banking and insurance are similarly situated and that the relationship between a bank and its depositor holding a non-interest bearing check account is quasi-fiduciary in nature. Affirming this view, the United States District Court in California[183] in 1987 held that the California Supreme Court did create a new tort of stonewalling in *Seaman's* distinguishable from the one created in *Commercial Cotton*, the difference being that while the former consists in denial of the contract, the latter consists in denial of liability. More importantly, the District Court, albeit without explanation, stated that these two variants of stonewalling are different from the tort of bad faith breach.

On the other hand, some California courts take the view that the tort of stonewalling was intended by the *Seaman's* court not as a "new intentional tort," but as a mere "subset, or one species, of the tort of breach of the implied covenant" of good faith and fair dealing.[184] These cases thus construed the *Commercial Cotton* ruling as standing for the proposition that stonewalling "constitutes a tortious breach of the covenant of good faith at least in those instances where a special relationship exists between the parties."[185]

Commercial Cotton pushed California jurisprudence to the brink. Had subsequent decisions pursued to the very logical end the conclusion that the banking relationship was quasi-fiduciary in nature and that banking in general belonged to the same special class as insurance, the

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181 *Id.* at 516.

182 Multiplex Insurance Agency, Inc. v. California Life Insurance Co., 189 Cal. App.3d 925, 934 (1987).

183 Elxsi v. Kukje America Corporation, (N.D. 1987), 672 F.Supp. 1294.

184 Okun v. Marton, 250 Cal. Rptr. 220, 231 (1988); *see also* Rogoff v. Grabowski, 246 Cal. Rptr. 185 (1988) and Koehrer v. Superior Court, 181 Cal. App.3d 1155 (1986).

185 Okun v. Morton, 250 Cal. Rptr. 220, 232 (1988).

tort of bad faith breach would have gained as much currency in banking as it has in insurance. Having seen what was in store beyond the edge, the California courts stopped in their tracks and backpedalled, apparently aware of the majority's caveat in *Seaman's*.

However divergent the construals of *Seaman's* be, they all converge on how the threshold finding of special relationship ought to be defined.[186] None takes issue with the five-step rule laid down in *Wallis v. Superior Court,*[187] to wit:

> (1) [t]he contract must be such that the parties are in inherently unequal bargaining positions; (2) the motivation for entering the contract must be a nonprofit motivation, i.e., to secure peace of mind, security, future protection; (3) ordinary contract damages are not adequate, because (a) they do not require the party in the superior position to account for its actions, and (b) they do not make the inferior party "whole"; (4) one party is especially vulnerable because of the type of harm it may suffer and of necessity places trust in the other party to perform; and (5) the other party is aware of this vulnerability.[188]

The five-step test purports to expound the special relationship rule. While supplying details, it does not make the standard set in *Seaman's*, later iterated in *Egan*, any more stringent than it already is. Cases applying this test illustrate the rigidity with which it has been interpreted. In *Multiplex Insurance Agency, Inc. v. California Life Insurance Co.,*[189] the plaintiff which relied on a bank to keep track of money owed it was deemed to have done so for a commercial purpose, i.e., to make money, and was, unlike the archetypal depositor with a noninterest bearing checking account, not impelled by a nonprofit motivation. In *Standard Wire & Cable Co.*[190] the plaintiffs, because they were represented by counsel for a credit agreement intended to make their business more profitable, were held not to have negotiated from an inferior bargaining position and were deemed not vulnerable. In *Gomez v. Volkswagen of America, Inc.,*[191] the availability of a statutory remedy allowing for treble damages in case of contractual breach was held not to have satisfied the requisite that denial of a

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186 Elxsi v. Kukje America Corporation [N.D. 1987], 672 F.Supp. 1294 and Okun v. Morton, 250 Cal. Rptr. 220 [1988], though representing the two antipodal sides of the question of whether stonewalling is a new tort or just an example of the tort of bad faith breach, agree that the latter tort requires a threshhold finding of the existence of a special relationship between the parties.

187 160 Cal. App.3d 1109 (1984).

188 *Id.* at 1118.

189 189 Cal. App.3d 925 (1987).

190 (C.D. Cal. 1988), 697 F.Supp. 368.

191 169 Cal. App.3d 921 (1985).

cause of action in tort would render judicial relief, both in its compensatory and punitive aspects, inadequate.

The special relationship rule and the amplificatory five-step test have been assailed as "analytically questionable."[192] Whatever the merits of this and other criticism, decisions applying the five-step test have invariably heeded the practical wisdom of not "exposing ordinary parties in commercial contracts to potentially substantial tort damages" which can instill "hesitancy to contract in the first place, or later, fear of defending energetically against uncertainties or mistakes."[193] While altruistic intervention is justified to quash the evil of unmitigated "unethical business practices"[194] engendered by the lack of proportionality in bargaining power, the equally detestable evil of "unfairly chill[ing] legitimate conduct"[195] must also be avoided. Tort liability for bad faith breach should not be so improvidently applied as to render it "incompatible with a free and competitive market."[196]

C. *Montana: Impermissible Unreasonableness*

Montana appears to be the only other jurisdiction in the United States where the tort of bad faith breach has been extended beyond the insurance context and is as developed as its counterpart in California. Although the tort evolved in Montana independently of the legal turmoil brewing in California, it did so also as an offshoot of the paternalistic precedents set in insurance law at about the same time the progenitors of *Seaman's* were being decided in California. Moreover, it emerged not without critical awareness of the doctrinal developments in California, particularly the limitation California was fixing on the noninsurance application of the bad faith doctrine.

As it was in California, the attempts early on to extend the tort to noninsurance contexts were plagued with "an uncertainty . . .

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[192] *See* Cohen, *Reconstructing Breach of the Implied Covenant of Good Faith and Fair Dealing as a Tort*, 73 CAL. L. REV. 1291, 1299 (1985) (This article advances four objections to the special relationship limitation. First, since the implied duty of good faith exists in every contract, there is no justification in distinguishing between special and ordinary relationships. Second, the limitation is both overinclusive and underinclusive because it inaptly depends on the nature of the relationship rather than on the nature of the conduct. Third, it fails to draw a distinction between breach of the implied covenant and mere bad faith breach of contract. Fourth, it does not explain why punitive damages are a proper remedy.).

[193] Quigley v. Pet, Inc., 162 Cal. App.3d 877, 891 (1984).

[194] *Id.*

[195] Cohen, *Reconstructing Breach of the Implied Covenant of Good Faith and Fair Dealing as a Tort*, 73 CAL. L. REV. 1291, 1301 (1985).

[196] Perdue v. Crocker National Bank, 38 Cal.3d 913, 943 (1985).

characteristic of any new area of law in our common law system."[197] In a 1979 case[198] the Montana Supreme Court latched on to what was then orthodoxy, i.e., that the "special considerations"[199] which attach the attributes of adhesion and inequality to, and are "inherent in[,] mass-produced and mass-marketed"[200] insurance contracts, "do not apply to an ordinary contract between businessmen."[201] Following a ground-breaking intimation in a 1981 decision that "some basis for implying covenants of good faith in contracts" may be found especially where "unconscionable conduct...must be deterred,"[202] the Montana Supreme Court, faced with a situation relative to which no duty of good faith had been mandated by statute,[203] held in 1982 that the Blue Cross, because of its stronger bargaining position, had an implied duty to act in good faith toward those applying for membership.[204] In *First National Bank of Libby v. Twombly*,[205] decided in 1984, a bank which in bad faith accelerated a borrower's indebtedness was held liable for punitive damages on the theory that it violated the good faith provision of the Uniform Commercial Code,[206] as well as from a consideration of the bank's superior bargaining power relative to the borrower. As held, the attribute of adhesion and the desideratum of realigning the disparity in bargaining power were crucial to the application of the tort. Without them, the cautionary clarification in a later case involving a dispute between a bank and its customer must be heeded, to wit: not "every contract or statutorily imposed obligation, alone, carries with it an implied covenant of good faith and fair dealing, the breach of which permits recovery in tort."[207]

In *Nicholson v. United Pacific Insurance Company*,[208] the Montana Supreme Court roughly shaped the contours of the tort of bad

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197 Nicholson v. United Pacific Insurance Co., 710 P.2d 1342, 1346 (1985).

198 First Security Bank of Bozeman v. Goddard, 593 P.2d 1040 (1979).

199 *Id.* at 1047, quoting Battista v. Lebanon Trotting Association, 538 F.2d 111, 117-18 (6th Cir. 1976).

200 Graham & Luck, *The Continuing Development of the Tort of Bad Faith in Montana*, 45 MONT. L. REV. 43, 45 (1984).

201 First Security Bank of Bozeman v. Goddard, 593 P.2d 1040, 1047 (1979).

202 Reiter v. Yellowstone County, 627 P.2d 845, 849 (1981).

203 *See* Owens v. Parker-Drilling Co., 676 P.2d 162 (Mont. 1984) (where the Court inferred the elements of adhesion and the implied duty of good faith from the fact that the legislature had statutorily prohibited an employer from dismissing an employee solely because the latter was handicapped).

204 Weber v. Blue Cross of Montana, 643 P.2d 198 (1982).

205 689 P.2d 1226 (Mont. 1984).

206 Sec. 1-203 of the Uniform Commercial Code provides: "Every contract or duty within this code imposes an obligation of good faith in its performance or enforcement."

207 Tribby v. Northwestern Bank of Great Falls, 704 P.2d 409, 419 (1985).

208 710 P.2d 1342 (Mont. 1985).

faith breach and distinguished it from the parallel doctrine in California. The case was elevated to that Court on appeal from a jury verdict to the effect *inter alia* that the defendant, a lessee, had on account of his intransigence regarding various aspects of a remodelling project in the leased properties, violated in tort its implied covenant of good faith and fair dealing. The Court, noting the *Seaman's* decision rendered in California the year before, expressed disagreement with the latter's extension of the tort doctrine "to all contract breaches as a matter of law,"[209] wherever a special relationship exists. Instead, the Court laid stress on the impermissibleness of the act complained of rather than on the nature of the relationship between the parties.

> Contract law is based in part upon the assumption that certain intentional breaches are to be discouraged. Permitting parties to breach their contracts promotes an efficient economy at least when the gains from the breach exceed the expected pecuniary injuries of the promisee....But whether performing or breaching, each party has a justifiable expectation that the other will act as a reasonable person....The nature and extent of an implied covenant of good faith and fair dealing is measured in a particular contract by the justifiable expectations of the parties. *Where one party acts arbitrarily, capriciously or unreasonably, that conduct exceeds the justifiable expectations of the second party.* The second party then should be compensated for damages resulting from the other's culpable conduct."[210]

The defendant, it bears noting, had argued that the plaintiff was not entitled to punitive damages inasmuch as Montana case law had not implied a duty of good faith and fair dealing for contracts in which the parties' bargaining positions were substantially equal. The Court, oddly enough, did not meet this argument. Had it done so, it would have ineluctably concluded from the facts that the parties were fairly and equally situated. The Court did not inquire whether the elements of adhesion or inequality were present in the relationship between the parties. It simply dwelt on the impermissible character of the defendant's conduct, relying on the California appellate court's interpretation of *Seaman's* in *Quigley v. Pet, Inc.*[211] *Quigley* viewed the tort of bad faith breach not in the context of whether it should be applied to noninsurance transactions but merely as a special tort arising from an "impermissible activity."[212] In effect, the *Quigley* court would emasculate *Seaman's* by consigning to irrelevance *Seaman's'* tortured

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[209] *Id.* at 1347.
[210] *Id.* at 1348 (Emphasis supplied).
[211] 162 Cal. App.3d 877 (1984).
[212] *Id.*.

delineation of the special relationship needed to expand the tort of bad faith breach beyond the insurance context. Were it not for this allusion to *Quigley*, the *Nicholson* court's approach would seem rather poorly conceptualized and tenuously argued considering that it had prefaced its opinion with an exhaustive survey of precedents that all but underscored the threshold necessity of adhesion and inequality.

However, *Nicholson* does not have the last word on the matter. In *Weinberg v. Farmers State Bank of Worden*,[213] decided in 1988, the plaintiffs sued their bank for, among other causes of action, failing to extend a line of credit in accordance with their agreement and were awarded punitive damages on the theory that the bank violated in tort its implied covenant of good faith and fair dealing. The Montana Supreme Court, affirming this judgment, used the standard of impermissible unreasonableness prescribed in *Nicholson*, explaining that "[a]lthough *Nicholson* did not involve a bank, the principles set forth are applicable to cases involving bank contracts and bank relationships with its customers."[214] It then proceeded to revive the element of adhesion or inequality as a precondition for the application of the tort of bad faith breach.

> The [debtors] testified that they were encouraged and advised by [the Bank] to expand their cattle operation. The [debtors] further testified that the Bank participated in and encouraged the changes to be made regarding the [debtors'] farming operation and that, coupled with the fact that the Bank controls the finances, created a fiduciary obligation to [the debtors] on the part of the Bank. In the immediate case, *there is sufficient indication of inequality of bargaining positions between the Bank and the [debtors]*. The Bank had the means to allow [the debtors] to continue to farm and if the Bank failed to advance the loan, the [debtors] would be forced out of their farming operations. As the bank officer testified, the [debtors] "had a choice," but one of the choices would wipe them out financially.[215]

Unless and until *Weinberg* is modified or superseded, adhesion or inequality is a doctrinal requirement of the tort of bad faith breach as it arises from a banking relationship and as it is understood in Montana, in addition to the precondition of impermissible unreasonableness.

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213 752 P.2d 719 (Mont. 1988).

214 *Id.* at 730-31 (Emphasis supplied).

215 *Id.* at 731.

D. Analysis of the California and Montana Doctrines

1. California

In California the tort of bad faith breach as a theory of lender liability requires the threshhold finding of a special relationship between the lending institution and its customer. The existence of this special relationship is to be determined according to the five-step test which inquires into: (1) whether the lending institution enjoyed a superior bargaining position *vis-a-vis* the customer; (2) whether the customer in entering into the contract was impelled by a nonprofit motivation; (3) whether the damages to be recovered under a contract theory would be inadequate in that they do not require the lending institution to account for its conduct and they fail to make the customer whole; (4) whether the customer was especially vulnerable and relied on the lending institution's performance to avoid harm; and (5) whether the lending institution was aware of this vulnerability.

A strict interpretation of the five-step test precludes a finding of special relationship in all banking transactions except where profit is not the customer's principal motivation. Arguably, one who borrows money to build a family home does not do so for profit and thus falls within the purview of the exception. The same rationale underlies the exception drawn with respect to a depositor with a non-interest bearing checking account. However, a businessman who secures a commercial loan is by dint of his profit motivation excluded by the test.

The five-step test does not apply where the lending institution is guilty of stonewalling, whether consisting in bad faith denial of a contract or bad faith denial of liability. In either case, the special relationship need not obtain. Stonewalling, in fact, may be classified as a separate and independent intentional tort and is not subsumable under the tort of bad faith breach.

The next step is to determine the presence of the objective and subjective elements of the tort. The objective elements are: (1) conduct, whether in the form of affirmative acts or mere inaction, on the part of the lending institution which (2) prevents the customer from (a) receiving the benefits of the underlying contract and accomplishing its purpose, or (b) obtaining adequate remedy in case of breach. Bad faith is the only subjective element.

The first objective element encompasses a wide range of conduct affecting the purpose of the underlying contract. A distinction must be made based on the stage of the contract process at which such conduct occured. This distinction will determine whether the second objective element applicable is the frustration of the benefit and purpose or the inadequacy of the remedy in case of breach. At this juncture, it will be useful to anchor the analysis on the rather prosaic conceptualization of the contract process as consisting of three stages, namely, formation, performance and enforcement.[216]

At the formation stage, commencing with the making of an offer and extending through the negotiations up to perfection, culpable conduct may be in the form of a false representation intended to induce the customer to execute, say a loan agreement. Exemplary of this is the verbal assurance that the term of the loan will be automatically extended in case the customer fails to repay the loan within the stipulated period. Since reliance on the representation will make the prospect of automatic extension a benefit the customer may justifiably expect, or part of what he reasonably contemplates to be the understood purpose of the agreement, the institutional lender's refusal upon demand to allow the extension of the term and its denial of its own representation may amount to a tortious violation of the implied covenant of good faith and fair dealing.

The stage of performance presents a conceptual difficulty. Not every failure or refusal to perform a contractual obligation, though made in bad faith, constitutes a tort, much less the tort of bad faith breach. Such non-performance, absent certain qualifying circumstances, "deprives the aggrieved party only of his contract rights to performance,"[217] which deprivation can be remedied by payment of compensatory damages for contractual breach. Tort remedies, like punitive damages, are in this situation unwarranted. A contrary view would make every breach of contract a tort. Aggrandizing tort in this manner would efface its boundary with contract. Moreover, interposing remedies in tort would unduly impinge on the expectations of the parties, one of which being the possibility of breach by either.

As mentioned, there are qualifying circumstances under which culpable non-performance becomes the tort of bad faith breach. Two of these are mentioned in Chief Justice Bird's lone dissent in *Seaman's*. The first is where the contracting parties "expressly indicate their understanding that a breach would be impermissible."[218] The second is when it is "clear from the inception of the contract that contract damages would be unavailable or would be inadequate compensation for

216 In this regard, the author takes off from the same theoretical premise used in Cohen, *supra* note 195, at 1315-25.

217 *Id.*

218 36 Cal.3d 752, 769 (1984).

the breach."[219] Both circumstances extend the zone of justified expectations beyond the substitutionary value of contract damages which are strictly compensatory. Either one entails no less than a commensurate award in punitive damages.

A rather simplistic illustration of the first circumstance is where the "parties inserted language into the contract stating that a breach would be unexpected or unacceptable."[220] Such a stipulation, however, is necessarily vitiated insofar as it purports to improperly allow the parties to fix tort liability for contractual breach.[221] Since the first circumstance mentioned by Chief Justice Bird admits of no other example, it must be rejected as unworkable.

The second circumstance, however, may be seen in a host of possible factual situations. For example, where the bank clearly understands that the loan it has agreed to extend is all that stands between the borrower and outright bankruptcy and by its own affirmative representations has impressed the borrower with its willingness and commitment to stave off bankruptcy, contract damages would not suffice to remedy the harm that the bank's unjustified withholding of the loan would inflict upon the borrower's reputation and credit standing.

The enforcement stage is less problematic. The question of what qualifies as a violation of a party's justified expectation has elicited useful commentary in the form of an illustrative catalogue of acts. The Restatement (Second) of Contracts reads:

> The obligation of good faith and fair dealing extends to the assertion, settlement and litigation of contract claims and defenses. The obligation is violated by dishonest conduct such as conjuring up a pretended dispute, asserting an interpretation contrary to one's own understanding, or falsification of facts. It also extends to dealing which is candid but unfair....Other types of violation have been recognized in judicial decisions: harassing demands for assurances of performance, rejection of performance for unstated reasons, wilfull failure to mitigate damages, and abuse of a power to determine compliance or to terminate the contract.[222]

Thus described, culpable conduct attending the enforcement stage involves defensive avoidance of the duty to pay compensatory damages

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219 *Id.*

220 Cohen, *supra* note 195, at 1321.

221 *Id.* at 1321-22.

222 RESTATEMENT (SECOND) OF CONTRACTS Sec. 205 (1981).

consequent to contractual breach. Conduct of this nature manifests an egregiousness warranting punitive damages. Here, the appropriate second objective element is the frustration of the aggrieved party's entitlement to the benefits of the underlying contract, not just the inadequacy of contract remedies in case of breach.

The lone subjective element of bad faith, which must concur with the objective elements, is equivalent to acting "unreasonably or arbitrarily" with manifest "unfaithfulness to an agreed common purpose or to the justifiable expectations" of the parties.[223] This implies actual knowledge of the invalidity[224] of the act or lack of belief in its validity.[225]

2. *Montana*

In Montana, lender liability based on the tort of bad faith breach attaches upon the concurrence of two conditions. The first is that adhesion or inequality pervades the relationship between the institutional lender and its customer. The second is that the institutional lender violates its contract with the customer in a manner or under circumstances that make it impermissibly unreasonable.

No rule or standard approaching the rather underinclusive specificity of the five-step test in California has been judicially formulated to gauge the presence of adhesion or inequality in the relational aspect of a banking transaction. Lack of parity in bargaining position is all that is required. This threshold condition, relative to the California rule, is overinclusive. It applies the tort to factual situations certain to be excluded by the five-step test. To illustrate, a commercial borrower is not, for the sole reason that he invests the proceeds of a loan in a business for profit, disabled from suing the bank under the tort theory of bad faith breach. Nor will the availability of adequate damages under a contract theory be preclusive as it is in California.

The second condition, impermissible unreasonableness, is satisfied by a showing that the act complained of is arbitrary, capricious and unreasonable. Montana case law does not distinguish between mere culpable non-performance of the prestation and bad faith denial of the contract itself. Moreover, no distinction is made amongst the various stages of the contract process. This simplifies the analysis

223 *See* Johnson v. Mutual Benefit Life Insurance Co. (9th Cir. 1988), 847 F.2d 600, 603.

224 Crisci v. Security Insurance Co., 66 Cal.2d 425, 432 (1967).

225 Cohen, *supra* note 195, at 1303.

considerably. It results that every arbitrary, capricious and unreasonable breach of the covenant of good faith and fair dealing at any stage of the contract process constitutes a tort of bad faith breach.

By discarding the technical nuance separating the two aspects of the implied covenant of good faith and fair dealing, i.e., performance and enforcement,[226] the Montana doctrine renders itself vulnerable to the criticism underlying much of the resistance to the tort theory of bad faith breach in state jurisdictions outside California and Montana that "[t]o sanction punitive damages on a bad faith theory would allow punitive damages whenever the breach was intentional"[227] and lead to a situation where the "exception would swallow up the general rule denying punitive damages for breach of contract."[228] This argument provokes a stinging rejoinder. The supposed threat to the integrity of the general rule is more apparent than real. Flexible as it is, the general rule has been weakened by the number of exceptions it admits of.[229] What, it may well be asked, is so sacrosanct about a rule so enervated by exceptions as to be hardly recognizable? Moreover, the general rule ignores for the most part that a "calculating and malicious contract breaker [can be] more culpable and more deterrable than those tortfeasors who act impulsively or recklessly and end up having to pay punitive damages" or that the "institution of contract is no less important to society than many interests which tort law protects."[230] This, however, is not to say that all intentional breaches of contract should warrant an award of punitive damages. Such an indiscriminate rule would have dire sociological consequences, ignoring as it does the practical virtues of allowing the players of the marketplace the freedom to compare the economic advantages of contractual breach with the burden of liability for compensatory damages, and to act accordingly.

There is another, perhaps more plausible way, of analyzing the Montana doctrine, to wit: The first condition, adhesion or inequality, is in a metaphysical sense not separate or distinct from impermissible unreasonableness. Therefore, it should be treated of as a subset of the bigger set of indicia of impermissible unreasonableness. This of necessity argues for an expansive interpretation of what qualifies as

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[226] RESTATEMENT OF THE LAW (SECOND) CONTRACTS Sec. 231 (1973) states: "Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement."

[227] Carrico v. Delp, 490 N.E.2d 972; 141 Ill. App.3d 684 (1988).

[228] *Id.*

[229] Burton, *supra*, note 119.

[230] Summers, *"Good Faith" in General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 VA. L. REV. 195, 256 (1968).

impermissibly unreasonable. Every breach of the lending transaction, where adhesion or inequality exists, would *ipso facto* be impermissibly unreasonable, absent a clear legal excuse or exculpatory defense. Thus the second condition subsumes the first.

Only with reference to the concept of adhesion can this analysis be understood. A contract whose terms "have been chosen by one of the parties and merely assented to by the other"[231] manifests adhesion and if such terms happen to include unconscionable ones, this contract must be construed *contra proferentum*. The rationale is rooted in a "rule of public policy,"[232] coarsely referred to by some as a rule "favoring the under dog"[233] and reinforced by the realization that given the traditional view of a contract as "the result of free bargaining of parties who are brought together by the play of the market, and who meet each other on a footing of approximate economic equality,"[234] there is a strident need for courts, in the context of modern commercial transactions based on contracts used by "enterprises with strong bargaining power and position,"[235] to intervene by construing these contracts in favor of the weaker party. It appears, therefore, that while contracts of adhesion should always be discouraged, courts will intervene only if such contracts actually contain unconscionable terms or where the stronger party seeks to construe in its favor terms which are ambiguous.

The factual setting in *Weinberg* is paradigmatic of the analysis proposed. There, the bank, capitalizing on the debtors' vulnerability and its control of their finances, induced them to expand their farming operations with assurances of additional credit indispensable to maintain such expansion. When the debtors did expand their farming operations, the bank withheld the promised credit. Inferrable from the court's ratiocination in holding the bank liable for tortious breach of the implied covenant of good faith and fair dealing is the notion that the bank had placed itself in such position of relational superiority *vis-a-vis* the debtors as rendered its subsequent refusal to extend credit impermissibly unreasonable.

This analysis of the Montana doctrine, although free from the conceptual convolution of its California counterpart, may be hard to defend against the criticism levelled by detractors of lender liability in general that it provides "no objectively identifiable guidelines concerning the bounds of legally permissible conduct," is "too broad and

231 3 A. CORBIN ON CONTRACTS 262 (1960).
232 *Id.* at 270.
233 *Id.*
234 Henningsen v. Bloomfield Motors, Inc., 32 N. J. 358, 161 A.2d 69 (1960).
235 *Id.*

inconcrete...as no workable limits to liability exist," and lets loose a "case-by-case approach...[which] is not appropriate for the remedy of damages."[236] To be sure, every norm of conduct relying on broad standards rather than on straightforward or prophylactic rules is hounded by the charge of overinclusiveness. But resort to standards is unavoidable in the regulation of certain areas of human endeavor. In such areas where standards have, through judicial and scholarly fine-tuning, been honed long and exquisitely enough, a measure of certainty and predictability has been attained. Fairness as a dictate of due process is a quintessential example. Corporate business judgment, to a lesser degree, is another.

IV. THE TORT OF BAD FAITH BREACH AS A VIABLE THEORY OF LENDER LIABILITY IN THE PHILIPPINE CONTEXT

A. The Implied Covenant of Good Faith and Fair Dealing

The implied covenant of good faith and fair dealing is not an unfamiliar fixture in the topography of Philippine contract law. It is embodied in articles 1159 and 1315 of the Philippine Civil Code.[237]

Article 1159 provides: "Obligations arising from contracts have the force of law between the contracting parties and should be complied with in good faith."

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236 Ebke & Griffin, *supra* note 5, at 798.

237 The Civil Code [hereinafter referred to as the CIVIL CODE], enacted by the Congress of the Philippines as Republic Act No. 386 on June 18, 1949, superseded the Spanish Civil Code of 1889 extended to the Philippines by the Royal Decree of July 31, 1889 towards the last decade of Spanish colonialization of the Philippines. The Civil Code rationalized and kept apace with the progressive legal developments in foreign jurisdictions what was then a heterogeneous body of civil law which, on account of its Spanish roots and American influences, the latter occasioned by almost fifty years of American suzereignty and tutelage, "did not conform, and were sometimes even antagonistic to [Philippine] customs and traditions." *See* A. TOLENTINO, 1 CIVIL CODE OF THE PHILIPPINES 11 (1974). To correct the situation, the Code Commission, which prepared the draft of the code, made "careful and enlightened selections from the modern unfolding of the Roman Law and of the English common law as well as to transform into positive law those native customs and traditions that are worthy of perpetuation, and to derive legal solutions from the postulates of morality and justice." *See* REPORT OF THE CODE COMMISSION 4 (1948).

Article 1159 is found in Chapter 1 (General Provisions), Title I (Obligations), Book IV (Obligations and Contracts); article 1315 in Chapter 1 (General Provisions), Title II (Contracts), Book IV (Obligations and Contracts).

The Civil Code was enacted in English. Accordingly, the English version prevails in case of conflict with any of the other translations. *See* REPORT OF THE CODE COMMISSION 6-7 (1948).

Article 1315 reads: "Contracts are perfected by mere consent, and from that moment the parties are bound not only to the fulfillment of what has been expressly stipulated but also to all the consequences which, according to their nature, may be in keeping with good faith, usage and law."

The good faith clauses of articles 1159 and 1315 are confluent. They limit the principle of autonomy of will and liberty of contract, expressed as general precepts of the articles, in order to mitigate its harshness. They also address the possibly invidious consequences of asserting literalism in the interpretation of a contract not only where this contract does not precisely or completely reflect the true intention of the parties but also where certain prescriptive formalities have not been performed. Finally, they incorporate into that which binds parties to their respective prestations a moral imperative, an ethical standard of honesty.

Article 1159 is a modified version of article 1091 of the Spanish Civil Code. The latter mandated compliance "in accordance with the tenor thereof"; the present article, on the other hand, provides that such compliance be "in good faith."[238] Article 1315 is a *verbatim* adoption of article 1258 of the Spanish Civil Code. Like article 1159, it stretches beyond the mere tenor of an agreement what the parties thereto are bound by. Its prescription of good faith is such that "[t]he binding force of a contract is not limited to what is expressly stipulated, but extends to all consequences which are the natural effect of the contract, considering its true purpose, the stipulation it contains, and the object involved." Notwithstanding their nuances, the common upshot of both articles is to enable the parties to enjoy the full benefit of the underlying contract and to realize its mutually understood purpose. In this sense do these articles coincide with the implied covenant of good faith and fair dealing.

In *Ramos v. Central Bank of the Philippines*,[239] involving a financially distressed commercial bank which was prevailed upon by the Central Bank to mortgage its properties in favor of, and to execute a three-year voting trust agreement making as trustee, the latter, all on the promise of the Central Bank to rehabilitate the commercial bank and stave off liquidation, the Supreme Court held that the Central Bank's move to liquidate the commercial bank without first granting the promised emergency funds was actionable as a form of contractual breach consisting of the failure to observe the good faith clauses of articles 1159 and 1315. The Court also chastised the Central Bank for

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238 4 A. TOLENTINO, CIVIL CODE OF THE PHILIPPINES 63 (1986).
239 41 SCRA 565 (1971).

using as a pretext to evade compliance, the commercial bank's violation of certain banking regulations which had been disclosed to it at the very outset. By interjecting this spurious defense, the Central Bank also ran afoul of articles 1159 and 1315.

Subsequent decisions construed article 1159 in a similar light. Notably, in *People's Car Inc.v. Commando Security Service Agency*[240] the defendant, a security agency contracted to secure the business premises of plaintiff, upon being apprised that one of its guards had stolen and later destroyed a car owned by a customer of the plaintiff, contended that the plaintiff should not have straightaway paid the customer the value of the damage to the car but should have instead challenged him to go to court and suggested that the plaintiff could always, in the suit to be filed by the customer, bring a third-party claim against the defendant. The Court described this suggested course of action as "unduly technical and unrealistic and untenable"[241] and commended the plaintiff for settling matters first with its customer and suing the defendant later for reimbursement. The Court explained tha the defendant's suggestion, if heeded, would violate article 1159.

> Such an approach of telling the adverse party to go to court, notwithstanding his plainly valid claim, aside from its ethical deficiency among others, could hardly create any good will for plaintiff's business, in the same way that defendant's baseless attempt to evade fully discharging its contractual liability to plaintiff cannot be expected to have brought it more business.[242]

The Court frowned upon what would plainly amount to stonewalling as this is understood in *Seaman's* and *Commercial Cotton*, on two grounds: ethical considerations, the very same considerations underlying the doctrines of bad faith breach in California and Montana, and the need to maintain business good will and , therefore, efficiency in commercial transactions. The Court did not view postulates of morality and economic efficiency as mutually exclusive and ineluctably antipodal.

A fitting exposition of the essence of article 1315 is found in a 1943 decision, *Abelarde v. Lopez*.[243] There the plaintiffs, who had previously sold their sugar plantations to the defendants, were claiming entitlement to a percentage of the concomitant sugar quota as consideration thereof on the theory that the sale did not include such sugar quota. The Court repudiated this claim, reasoning that the sugar

240 51 SCRA 40 (1973).
241 *Id.* at 46.
242 *Id.*
243 74 Phil. 344 (1943).

quota was "one of the consequences of the conveyance of the sugar lands, conformably with good faith, customs and laws"[244] considering that these lands "were practically of no use to the landowner without the sugar allotment."[245] An attempt by the plaintiffs to avoid for lack of registration a deed of conveyance in which it was stated that the defendants had by reason of the sale also acquired "*cualquier derecho, titulo, interes, participacion, accion, renta*" was given short shrift "because it being clear...that the parties intended to include the sugar quota, the registration of the deed and the description of the sugar coefficients are mere formalities to be subsequently followed, which do not in the meantime render the transaction ineffective."[246] The plaintiff's refusal to perform these formalities was deemed a violation of the duty of good faith. Explained the Court:

> But the noncompliance with the contract by the subsequent refusal of [the plaintiff] to sign the forms is now turned by them into an argument precisely to show there was no intention to sell the allotnent, thus taking advantage of their own wrong. Such ingenious manner of evading a covenant can not be tolerated, much less sanctioned. Cleverness should never take the place of the loyal, upright and straightforward observance of plighted undertakings. It is mostly these subterfuges that courts guard against in passing upon litigations on contracts, for rarely does any party bent upon infringing his stipulations ever brazenly do so; some adroit and specious pretext is usually set up with vigor.[247]

B. Articles 19 and 21 and the Tort of Bad Faith Breach

1. Contracts, in General

Half the task of conceptualizing a Philippine tort of bad faith breach was accomplished by proof of the existence of an analogue of the implied covenant of good faith and fair dealing within the purview of articles 1159 and 1315. Completing it entails a consideration of articles 19 and 21.

Article 19 provides: "Every person must, in the exercise of his rights and in the performance of his duties, act with justice, give everyone his due, and observe honesty and good faith."

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244 *Id.* at 347.
245 *Id.* at 346.
246 *Id.* at 347.
247 *Id.* at 348.

Article 21 states: "Any person who wilfully causes loss or injury to another in a manner that is contrary to morals, good customs or public policy shall compensate the latter for the damage."

Both articles are new. They are also among the salient provisions of Chapter 2 (Human Relations) of the Preliminary Title of the Civil Code. This chapter was intended to subserve two important policy objectives. The first is to--

> ...indicate certain norms that spring from the fountain of good conscience,...guides for human conduct [that] should run as golden threads through society, so that the law may approach its supreme ideal, which is the sway and dominance of justice.[248]

The second is to "vouchsafe adequate legal remedy for that untold number of moral wrongs which it is impossible for human foresight to provide for specifically in the statutes."[249]

These two objectives operate in tandem. Article 19 lays down the norm; article 21 amplifies it and, in addition, establishes an independent cause of action by affording a remedy in damages. To be ignored is the ill-conceived *obiter dictum* in a fairly recent case to the effect that all the provisions in the chapter on Human Relations are "merely guides for human conduct in the absence of specific legal provisions and definite contractual stipulations."[250]

Article 19 adopts the Swiss concept of abuse of right embodied in article 2 of the Swiss civil code, to wit: "Every person is bound to exercise his rights and fulfill his obligations according to the principles of good faith. The law does not protect the manifest abuse of right."[251] This concept is more expansive than its analogues in Mexico, China and Germany, which create liability only if the right is exercised solely to injure.[252] By contrast, the Swiss concept imposes liability even if the right is exercised with utility to the one to which it pertains. Such a concept may clash with the invaluable economic insight noted in Chief Justice Bird's dissent in *Seaman's* that society ought not to penalize contractual breaches motivated by the desire to avoid serious economic harm or maximize economic advantage. To harmonize them, it may be sensible to interpret the Swiss concept as only imposing compensatory

248 REPORT OF THE CODE COMMISSION 39 (1948).

249 *Id.* at 40.

250 De Tavera v. Philippine Tuberculosis Society, Inc., 112 SCRA 243, 254 (1982).

251 1 A. TOLENTINO, CIVIL CODE OF THE PHILIPPINES 62 (1985).

252 *Id.*

damages where the breach is committed with such utility in mind, i.e., avoidance of economic harm or enjoyment of economic advantage, and reserving the sanction of punitive damages for violations that are truly egregious.

Article 19 has been analyzed on the basis of an old Spanish Supreme Court ruling breaking down the principle of abuse of right into the following elements:

> (1) The exercise of a right which is objective and apparently legal; (2) Damage or injury to an interest not specifically protected by legal precept; (3) Immorality or anti-social character of the damage or injury manifested either subjectively, i.e., when the right is exercised with the intent to injure or simply without a serious or legitimate purpose, or objectively, i.e., when the damage results from the excess or abnormality of the exercise of the right.[253]

The qualification to the second element, i.e., that the damage or injury be to an interest not specifically protected by legal precept, inaptly makes a distinction when the language of article 19 does not. Moreover, it is unjustifiably restrictive. It would limit the application of article 19 to those abuses that cannot be otherwise remedied by a specific legal precept. Since "legal precept" is a broad enough term to include any legal principle, e.g. that in contract law which entitles the aggrieved party to compensatory damages in case of breach, the number of transactional situations to which article 19 would apply would be virtually nil. The qualification would thus make article 19 counter-intuitive.

On the whole, however, the proposed analysis, *sans* the qualification to the second element, comports well with the spirit of article 19. Its requirement that the exercise be immoral or anti-social, i.e., where it is "abnormal" and where it "violate[s] the concept of social solidarity which considers law as rational and just,"[254] reflects the distinction that has been drawn between contractual breaches which, not being invidious, are productive of some economic utility to either the breaching party or the economic system as a whole, and those that are not. This requirement also coincides with the concept of good faith defined in the context of article 19 as "honest intention to abstain from taking any unconscientious advantage of another, even though the forms or technicalities of the law, together with an absence of all

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253 1 E. CAGUIOA, CIVIL LAW 32 (1962).

254 1 A. TOLENTINO, *supra* note 251, at 64.

information or belief of facts which would render the transaction unconscientious."[255]

Article 21 enshrines the principle proscribing acts *contra bonos mores* and was lifted from article 826 of the German Civil Code of 1900, which states: "He who in a manner contrary to good customs wilfully causes injury to another, shall be obliged to indemnify for the damage caused."[256] Therefore, German jurisprudence, though not binding, should be persuasive in the interpretation of article 21.[257] A decision rendered by the *Oberlandesgeritch* (appellate court) of Cell on December 5, 1947 shows how the two requisites of this article, wilfulness[258] and conduct *contra bonos mores*, are satisfied. That case was commenced by a war refugee who fled her home in East Prussia and escaped to Goettingen at the height of the Nazi invasion of Russia. She made the mistake of describing the atrocities committed by the Nazis in East Prussia to the two defendants, one of whom reported her to the Gestapo. The other defendant, upon interrogation by the Gestapo, confirmed her co-defendant's account. The plaintiff was imprisoned and after the wa. she sued the defendants for damages under article 826. The court, rendering judgment in her favor, held that the act of reporting the plaintiff to the Gestapo was wilfull because made with knowledge of its effects, i.e., certain capture and imprisonment by the Gestapo. On whether this act was also *contra bonos mores*, the court brushed aside this defendant's contention that he was motivated by an honest conviction that the plaintiff would receive fair and just treatment, explaining that:

> So long as it can be anticipated that a person reported to the competent authorities will be treated in an orderly proceeding, governed by humane principles, such denunciation would not be *contra bonos mores*, at least not in the absence of improper motives. Such orderly proceeding would have been the rule in former times. There was no Gestapo. There were no Gestapo methods.
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> But things were entirely different at a time when the most trivial political denunciation was sufficient to deliver the denounced person to the whims of so arbitrary an institution as the Gestapo.[259]

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255 *Id.*

256 *Id.* at 72.

257 *See* R. MARTIN, HANDBOOK OF STATUTORY CONSTRUCTION 157 (1972). *See also* Caine v. Bowlby, 114 F. 2d 519 (1940) (where it was held that interpretation of a statute by courts of the state whence the statute was borrowed is persuasive).

258 Wilfullnes perforce connotes an intentional act. *See* A. VON MEHREN, THE CIVIL LAW SYSTEM 580 (1977).

259 Quoted from a digest of the case appearing in 1 A. TOLENTINO, *supra* note 251, at 74-75.

Philippine case law growing out of articles 19 and 21 is relatively sparse.[260] *Velayo v. Shell Company of the Philippines*[261] is the seminal case. The defendant was one of the principal creditors of an insolvent corporation. When it became clear that the insolvent corporation could not go on doing business, these principal creditors, in a meeting called by the insolvent corporation, promised not to pursue their respective claims judicially, and agreed to divide extra-judicially the insolvent corporation's assets *pro rata*. They also agreed that a cargo plane belonging to the insolvent corporation and located at that time in California would be sold and its proceeds collated with the other assets. The defendant, a day after assenting to this arrangement, surreptitiously assigned by telegraphic transfer its credit to a sister company based in the United States which lost no time in bringing suit for collection in California and in attaching the plane. The other creditors sued, asking for injunctive relief and alternatively, for damages in an amount double the value of the plane. The trial court, giving credence to the defendant's contention that it had violated no law and had simply assigned its credit in the regular course of business, dismissed the complaint. On appeal, the Supreme Court reversed, hinging its decision on articles 19 and 21. Holding that the "declaration of principle contained in article 19 is implemented by [a]rticle 21,"[262] the Court found the defendant liable for compensatory damages equal to the value of the plane and exemplary damages by way of example or correction for the public good. The defendant's culpability arose from its bad faith breach and betrayal of the confidence engendered by its

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260 Most of the cases involve breach of the promise to marry where liability is imposed only for actual damages, e.g., wedding expenses incurred in advance of the wedding that never materializes. *See* Domalagan v. Bolifer, 33 Phil. 471 (1916); Pe v. Pe, 5 SCRA 200 (1962); Hermosisima v. Court of Appeals, 109 Phil. 629 (1960). That breach of the promise to marry is the only illustrative paradigm presented in REPORT OF THE CODE COMMISSION 40 (1948) probably explains why lawyers have not been quick and creative enough to invoke article 21 in other factual situations. Another plausible explanation is that the Spanish concept of *quasi-delict* as embodied in article 2176, being a more familiar concept, has become a sort of legal Swiss Army knife, albeit inaptly, inasmuch as article 2176 applies strictly to cases of negligence. Art. 2176 reads: "Whoever by act or omission causes damage to another, there being fault or negligence, is obliged to pay for the damage done. Such fault or negligence, if there is no pre-existing contractual relation between the parties, is called a *quasi-delict....*" *See* Carpio, *Intentional Torts in Philippine Law*, 47 PHIL. L. J. 649, 690 (1972).

261 100 Phil. 186 (1956). *See also* Philippine National Bank v. Court of Appeals, 83 SCRA 237 (1978) (where the Court, using the same standard of care applicable to negligent torts, i. e., *quasi-delict*, held that under article 21, one has the duty to observe the "degree of care, precaution and vigilance which circumstances justly demand," which holding brings *quasi-delict* within the scope of article 21 and gives the latter an even broader coverage than its source, article 826 of the German Civil Code of 1900, which applies only to intentional torts).

262 *Id.* at 202.

agreement with the other creditors in a manner contrary to morals and public policy. Underscored was the fact that among the evils sought to be suppressed by articles 19 and 21 "are the many business practices that are unfair or oppressive."[263]

Velayo is significant in three respects. Firstly, it holds that articles 19 and 21, construed together, establish an independent cause of action, the former delineating a norm of conduct based on postulates of morality, the latter implementing it with fitting sanctions.

Secondly, its analysis coincides with the test used in the aforementioned 1947 German case in ascertaining whether the act complained of is wilful and *contra bonos mores.* The defendant in *Velayo* demonstrated its willfulness by the shrewd and calculated manner in which it abused the confidence of the other creditors and ensured the injurious result intended. In concluding that the perfidious assignment of credit was *contra bonos mores,* the Court invoked the same postulate of morality, adjusted to apply to the commercial context of the factual situation.

Lastly, *Velayo* suggests that the duty of good faith subsists even in a contractual context, thus entitling the aggrieved party to proceed against the contract breaker either for breach of contract or for damages under the tort remedies of articles 19 and 21. In *Velayo,* the evidence indicated the existence of a perfected agreement among the creditors to forego judicial remedies and to divide the insolvent's assets extra-judicially. Arguably, the creditors worsted by the defendant's wily machination could simply have sued for breach of this agreement and still have obtained an award in punitive damages considering that article 2232 of the Civil Code provides that "[i]n contracts and quasi-contracts, the court may award exemplary damages if the defendant acted in a wanton, fraudulent, reckless, oppressive or malevolent manner."[264]

2. *Articles 19 and 21 and the California and Montana Rules of Bad Faith Breach*

Articles 19 and 21 are sufficiently broad to accomodate the California doctrine of bad faith breach as a theory of lender liability. The special relationship needed to bring a particular banking transaction within the purview of the theory is not a threshold condition under articles 19 and 21 and may be considered as only evidentiary of immorality or anti-socialness under article 19 and of

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263 *Id.* at 203.

264 CIVIL CODE, art. 2232.

conduct *contra bonos mores* under article 21. The agonized distinctions so dispositive in applying the California doctrine to the different stages of the contract process become adventitious under these articles. The characterization of the offending act being the principal issue, liability under these articles will attach irrespective of the stage at which the breach is committed. This logically obviates the requisite showing of any of the qualifying circumstances, two of which are mentioned in Chief Justice Bird's lone dissent in *Seaman's*, where the breach occurs at the stage of performance.

Similarly, the adhesion or inequality required as a threshold condition by the Montana doctrine need not exist to establish liability under articles 19 and 21. If present, it may just be an indicium of egregiousness, i.e., immorality or anti-socialness under article 19 and the quality of being *contra bonos mores* under article 21. Thus, that the plaintiff is a commercial borrower and, at the same time, a corporation with roughly the same bargaining power as the institutional lender, will not preclude recovery under these articles. Indeed, the analysis proposed according to which adhesion or inequality is treated not as a separate element but only as an earmark or badge of impermissible unreasonableness is close to the spirit of articles 19 and 21.

To better apprehend these conceptual juxtapositions, *Development Bank of the Philippines v. Intermediate Appellate Court*,[265] decided in 1985, should be considered. The plaintiff, a food processing corporation plagued with liquidity problems, obtained a dollar loan from a New York lending institution. The loan was guaranteed by the defendant, a local bank. To protect the defendant, the plaintiff executed in the latter's favor a mortgage of its securities. The mortgage indenture contained a Discretionary Clause, which read: "The proceeds of the loan shall be released at the discretion of the mortgagee after the registration of the deed of mortgage." It also featured a complementary Permissive Clause, which read: "MORTGAGOR shall deposit with the MORTGAGEE the proceeds of the cash dollar loan...with which shall be made available for payment of MORTGAGOR'S obligations to local financial institutions and for working capital." The plaintiff had various outstanding accounts to different local creditors and the defendant was empowered to receive the loan proceeds for the plaintiff's account and to pay from these proceeds the plaintiff's debts. The term of the loan was one year but it was renewable yearly for a period of ten years provided the plaintiff pay the interest at the end of the first year. When the plaintiff defaulted in the payment of this interest, the New York lending institution endorsed all the negotiable notes made by the plaintiff and guaranteed by the defendant.

[265] 140 SCRA 338 (1985).

Constrained to pay the bearers of these notes, the defendant foreclosed the mortgage. It appeared that as of the time of this foreclosure, the defendant had managed to release only a portion of the loan proceeds all in partial payment of the plaintiff's creditors. The plaintiff sued, alleging *inter alia* that the defendant was unreasonably slow in releasing the loan proceeds, and asked for actual damages on the ground that the defendant failed to release money for the plaintiff's working capital and thus prevented the plaintiff from resuming operations. The plaintiff also prayed for exemplary damages and attorney's fees. The trial court rendered judgment in favor of the plaintiff granting all the damages prayed for. The Intermediate Appellate Court upheld for two reasons. First, it could not infer from the evidence any grant of discretionary authority to the defendant. Second, assuming *ex argumenti* that there was such a grant, it could "*not include its capricious and whimsical exercise amounting to an evasion of a positive duty or a virtual refusal to perform an obligation arising from a contract.*"[266] On appeal, the Supreme Court reversed, holding that the Discretionary Clause and Permissive Clause embodied the grant of discretionary authority and that while the Intermediate Appellate Court correctly defined what constitutes culpable abuse thereof, it overlooked evidence of such abuse. Explained the Court:

> Since [the plaintiff] had obligations in favor of *several* financial institutions, *and there was no specification as to its need for working capital, it should be clear that [the defendant] had to make decisions as to which obligations, and how much thereof, should first be paid, with retention of a reasonable amount for [the plaintiff's] working capital needs.* In other words, allocations to creditors and to [the plaintiff] had to be made by the [defendant] at its *discretion....*
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> The objective of the discretion lodged in [the defendant] was to place [plaintiff], if at all possible, on a viable basis with ability eventually to settle all its debts inclusive of what it owed [the defendant] itself. That was a difficult decision to make in one stroke, considering the factors which arose after [the defendant] received the proceeds of the dollars of the loan. First was the notice of levy filed by [the plaintiff's] labor union on the properties mortgaged to [the defendant]. Then there was the controversy which evolved in regards [*sic*] to [the plaintiff's] indebtedness to China Bank.
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> x x x

266 *Id.* at 350 [Emphasis supplied].

> If [the defendant] had given the entire proceeds then being retained to [the plaintiff], unpaid créditors, including China Bank (not to mention [the defendant] itself), could have all pounced on [the plaintiff], and that could have hampered its then possible rehabilitation.[267]

While neither the Intermediate Appellate Court nor the Supreme Court used the language of, much less alluded to, articles 1159 and 1315, their common conception as to what constitutes abuse of discretion dovetails with the doctrinal definition of good faith embodied in these articles. This conception is commodious enough to subsume the implied covenant of good faith and fair dealing as this is known in the United States.

The Supreme Court deemed crucial the fact that the plaintiff's need for working capital was not specified. If such were so specified, judicial ratiocination would be as disparate as the results it would yield. Thus if this altered factual situation were decided under Montana's doctrine of impermissible unreasonableness, the plaintiff's suit would doubtless prosper. Adhesion or inequality, treated of as a separate and distinct element, would be inferred from the fact that the plaintiff, being financially strapped and for that reason vulnerable, was in an inferior bargaining position relative to the defendant. The defendant's procrastination aggravated by its knowledge of the specific working capital needs of the plaintiff would be impermissibly unreasonable. If adhesion or inequality, as proposed, is not a separate and distinct element but just an indicium of impermissible unreasonableness, with greater reason should the plaintiff's suit prosper. Prescinding from the notion of relative bargaining power, the circumstances attending the mortgage, e.g., the plaintiff's dire financial need and the defendant's discretionary authority, as well as its knowledge of the plaintiff's vulnerability, all combine to make it impermissibly unreasonable for the defendant to acts as it did. The plaintiff's predicament would be no different from that of the debtors in *Weinberg*.

Consideration of the same altered factual situation under articles 19 and 21 compels the same result. The three elements of abuse of right under article 19 would be present. The defendant had an objective and legal right to exercise its discretion to apply the loan proceeds as agreed upon. Because the defendant did not release the entirety of these proceeds, the plaintiff failed to get all the working capital it needed to resume commercial operations. Lastly, the acts of the defendant were immoral and anti-social in that subjectively, they lacked a serious or

267 *Id.* at 350-51 [Emphasis supplied].

legitimate purpose and objectively, they abnormally exceeded the bounds of the defendant's discretionary authority. These acts would also exhibit the willfulness required by, and would be *contra bonos mores* under article 21. The defendant, cognizant of the amount of working capital needed to keep the latter's business going, certainly knew that by withholding it, plaintiff's enterprise would go down the drain. Such conduct is no different from the defendant's perfidy in *Velayo*.

By contrast, a California court appraising the same altered factual situation need not inquire into whether the fact that the working capital requirement was specified would be dispositive under the California doctrine of bad faith breach. For the plaintiff's suit would be rejected at the very threshold by the five-step test. Having contracted the loan and the accessory mortgage to pay off its creditors, obtain working capital and regain commercial viability, it cannot be said that plaintiff was impelled by other than a nonprofit motivation.

C. *Juristic Compatibility: Collateral Considerations*

The foregoing finds further support in three considerations showing the theory's juristic compatibility with the Philippines legal system.

Firstly, the Philippines' hybridized legal system and its composite concept of tort do not inveigh against the tort theory of bad faith breach. This system possesses a strong civil law tradition implanted in this jurisdiction under the Spanish colonial regime. It is, however, influenced by a continuing infusion of Anglo-American common law precepts. Shortly after the transition to American rule, the Philippine Supreme Court declared that "neither English nor American common law is in force in [the Philippines], nor are the doctrines derived therefrom binding upon [Philippine] courts, save only in so far as they are founded on sound principles applicable to local conditions."[268] Spanish civil law antecedents governed, deferring to American common law principles only by way of exception, as when these principles were "so deep seated in [the American common law] system that we should regard it as carried into the Philippines by implication."[269] Gradually, as the volume of common law precepts borrowed from the United States jurisdictions rose, it dawned that "many of these laws can only be construed and applied with the aid of the common law from which they are derived, and that to breathe the breath of life into many of the institutions introduced in [the Philippines] under American sovereignty,

268 United States v. Cuna, 12 Phil. 241, 244 (1908).

269 Alzua and Arnalot v. Johnson, 231 U. S. 106, 58 L. Ed. 142 (1913).

recourse must be had to the rules, principles and doctrines of the common law under whose protecting aegis the prototypes of these institutions had their birth."[270] Justice Malcolm would observe on the twentieth year of American rule that American citations in reported decisions of the Philippine Supreme Court were more than ten times as many as the Spanish citations,[271] concluding rather grandiosely that "the principles of the Anglo-American Common Law are for the Philippines, just as they were for the State of Louisiana and just as the English Common Law was for the United States, of far-reaching influence."[272] Stressing that "[t]he Commom Law is entitled to our deepest respect and reverence,"[273] he predicted that a Philippine Common Law "will continue..., based upon the English Common Law in its present day form of an Anglo-American Common Law, which...is effective in all of the subjects of law in this jurisdiction."[274] In particular, articles 19 and 21, though Swiss and German, respectively, in origin, have established a gradient for the inflow of American concepts of intentional tort.[275] The opinion of one commentator that "slavish reverence for American precedents as such is not desirable because it tends to create confusion in our legal system which is basically civil law"[276] does not hold with respect to articles 19 and 21. For one thing, the broad language of these articles, coupled with their catch-all purpose as inferred from their *ratio legis*, allows for profuse borrowing of consistent American tort principles. For another, in the Philippines legal ratiocination is governed by the principle of *stare decisis et non quieta movere*.[277] Decisions of the Supreme Court must be applied to analogous cases which follow, though the parties be different. However, to avoid doctrinal ossification, legal reasoning, as practiced, is never mechanical. The tyranny of precedent is rejected. Subordinate courts may distinguish cases; the Supreme Court can, under compelling circumstances, overrule established doctrine. A dissenting opinion, which is always reported together with the majority opinion, may with time become law.[278] The situation in the United States is no different.[279]

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270 Alzua and Arnalot v. Johnson, 21 Phil. 308, 332 (1912).

271 *In re* Shoop, 41 Phil. 213, 251 (1920).

272 *Id.* at 254.

273 *Id.*

274 *Id.* at 252-53.

275 *See* Carpio, *Intentional Torts in Philippine Law*, 47 PHIL. L. J. 649 (1972).

276 H. JARENCIO, TORTS AND DAMAGES IN PHILIPPINE LAW 14 (1979).

277 J. M. Tuazon & Co., Inc. v. Mariano, 85 SCRA 644 (1978).

278 *See* Lichauco, *Studying Law Thru Cases*, 11 PHIL. L. J. 48 (1931).

279 A. VON MEHREN, THE CIVIL LAW SYSTEM 1133-34 (1977).

Secondly, the lingering, albeit enfeebled, objection to the tort of bad faith breach as blurring the line between tort and contract[280] applies with less vigor to the Philippine analogue of this tort. In the Philippines, bad faith contractual breach gives rise not only to compensatory damages but also to moral damages arising *inter alia* from mental anguish, serious anxiety, besmirched reputation, wounded feelings, moral shock and social humiliation, provided they are the proximate result of the breach.[281] Moreover, where the breach is wanton, fraudulent, reckless, oppressive or malevolent, exemplary damages, which are analogous to, and interchangeable with, punitive damages in the United States jurisdictions,[282] may be imposed "by way of example or correction for the public good."[283] This differentiates the Philippines from civil law jurisdictions, like France,[284] where nonperformance of a contractual obligation, even though occasioned by the obligor's wilful misconduct, does not result in liability in damages beyond that imputable to the direct and immediate consequence of the breach. To a greater degree than what has been seen in the United States, the ready availability in the Philippine context of tort remedies to contractual breach renders less important the traditional distinction between tort and contract. This ascribes to the composite concept of Philippine tort, consisting of the Spanish *quasi-delict* and the American tort. Notwithstanding the statutory definition of *quasi-delict* as referring only to where there is no contractual relation between the parties, Philippine case law states otherwise. Thus, although the juridical nexus between the parties be "contractual both in origin and nature, the act that breaks the contract may be a tort."[285] This is especially true with respect to articles 19 and 21 whose very tenor does not distinguish between whether the parties are related in contract or not.

Lastly, juristic bias in the Philippines has moved almost full circle from a well-nigh uncompromising adherence to the principle of contractual autonomy to a calibrated deference to the dictates of the common good or the interest of the weaker party. At a time when welfare legislation imposing on employers greater economic burdens than they would otherwise bargain for with their workers were struck down for infringing the freedom of contract,[286] courts reacted with

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280 Sullivan, *Punitive Damages in the Law of Contract: The Reality and the Illusion of Legal Change*, 61 MINN. L. REV. 207, 249 (1977).

281 CIVIL CODE, arts. 2217 and 2220.

282 H. JARENCIO, *supra* note 276, at 359.

283 CIVIL CODE, arts. 2232 and 2229.

284 THE FRENCH CIVIL CODE, art. 1151.

285 Air France v. Carrascoso, 18 SCRA 155, 168 (1966).

286 People v. Pomar, 46 Phil. 440 (1924).

skepticism to plaints arising from unequal bargains. Later, to comply with such constitutional imperatives as social justice,[287] the drafters of the Civil Code established a presumption "in favor of the safety and decent living for the laborer" to be used in resolving ambiguities in a labor contract.[288] The same judicial solicitude was prescribed for all kinds of contracts. Article 1306 provides: "The contracting parties may establish such stipulations, clauses, terms and conditions as they may deem convenient, provided they are not contrary to law, morals, good customs, public order or public policy." The public policy limitation was intended by the drafters to subsume all "considerations which are moved by the common good."[289] In addition, the rise of "monopolies, cartels and [the] concentration of capital, endowed with overwhelming economic power" and able "to impose upon parties dealing with them cunningly prepared 'agreements', [aptly called contracts of adhesion] that the weaker party may not change" has elicited judicial sympathy for the weaker party.[290] Finally, the move, prodded by the drafters of the Civil Code, to "place equity and justice above strict legalism and form," stressing the "spirit that giveth life rather than the letter that killeth,"[291] has produced a sizeable body of equity principles. These and other legal changes in Philippine legal theory reflect the growing tension between individualism and altruism.

V. CONCLUSION

A. Debunking Policy Objections Grounded on Economic Efficiency

To its detractors, lender liability is so unsettling that the urge to quash it lest it breed further has gone beyond resisting borrowers' suits within the confines of courtrooms to raising all sorts of policy objections in political and academic fora. The most riveting of these objections, relying upon the rather voguish economic efficiency argument, have nothing but the direst prognostications for a society enamored of lender liability. One variant[292] of this argument, which applies to lender liability in general, proceeds from the premise that since credit must be readily available at the lowest possible cost, institutional lenders are sacred cows which, in order to provide such credit, must be allowed to shift lending risks to borrowers. Lenders need assurance that the loans

287 REPORT OF THE CODE COMMISSION13 (1948).

288 CIVIL CODE, art. 1702 reads: "In case of doubt, all labor legislation and all labor contracts shall be construed in favor of the safety and decent living for the laborer."

289 REPORT OF THE CODE COMMISSION 134 (1948).

290 Fieldman Insurance v. Vargas, 25 SCRA 70, 75 (1968).

291 REPORT OF THE CODE COMMISSION 26 (1948).

292 Borders, *supra* note 64, at 742-52.

they extend are repaid, together with the expected return on their investment. Thus they should be able to impose upon borrowers strict and sometimes onerous terms. Without these terms, borrowing cost will increase to minimize lender risk. If borrowers reject these terms, lenders can simply invest more money in evaluating the risks attending every loan application and pass on the added cost of this process to borrowers by way of higher interests; or they can limit their market to low-risk portfolios. Lender liability, it is argued, by proscribing such strict or onerous terms in loan contracts, leaves lenders with no alternative save to invest more money in risk-evaluation, thereby increasing borrowing cost, and discriminate against small or high-risk borrowers. More directly, lender liability encourages defaults or late payment of loans either one of which entails higher lending costs which lenders shift to borrowers by way of higher interests. All this makes for tight credit the societal impact of which is to deny the economy adequate financing for new businesses, as well as for research and development, and to kill off small business enterprises, leaving the bigger ones to monopolize the market. Consequently, the gross national product will fall and society will lose all the efficiency-promoting benefits of competition.

This argument is flawed by its oversight of the lender's share of the duty to maintain a sound credit structure. While making debtors judgment-proof, whether by lax bankruptcy laws or liberal standards of lender liability, will make credit "available only to those who don't need it--those with unlimited resources,"[293] allowing lenders to rely solely on the collection laws, casting aside astute credit decision-making, is to reap a harvest of defaults and bankruptcies which, in the long run, will undermine not only the credit system[294] but economic stability as well. Acting, however, as a check on credit, lender liability will instill good credit judgment which, in turn, will strengthen the system of credit.

Another variant of the economic efficiency argument, especially relevant to the tort theory of bad faith breach, is that commercial overreaching is an incentive to economic efficiency and that a punitive approach to bad faith breach of contract will chill economic activity.[295] This argument flows from the individualist credo that production and exchange are optimized by supplanting liability law with the "sanction of abandonment"[296] which essentially consists in letting "people starve (or fall to very low levels of welfare) before

[293] Shaw, *Credit: A Way of Life*, CREDIT, June 1975, at 12.

[294] *Federal Bankruptcy Judge Joe Lee Discusses the Bankruptcy Act of 1978*, CREDIT, July/Aug. 1980, at 22.

[295] Diamond, *supra* note 120, at 433.

[296] Kennedy, *supra* note 65, at 1742.

forcing others to help them."[297] Fear of destruction heightens individual vigilance; self-reliance eliminates the less wary and places in the hands of the more cautious the modes of production and exchange.[298]

This argument is not unanswerable. For one thing, the rather Darwinist notion that strict contractual autonomy maximizes wealth by promoting efficiency, presupposes a purely free market economy where competition is untrammeled. No such system exists; nor one approximating it ever will. It is a chimera, a shadow. For another, condoning bad faith breach in the lending context will, in the long run, encourage egregious conduct which has as chilling an effect on economic activity as excessive regulation. The sanction of abandonment contemplates betrayals of a milder sort, those which, without offending sound business ethics, an obligor may commit, to protect an economic advantage or avoid a far greater economic loss to himself, without being liable beyond the reasonable value of compensatory damages. Transgressions of this sort may be allowed without punitive sanctions as a concession to "modern commercial realities."[299] But the line should be drawn in regard to invidious conduct such as bad faith contractual breaches characterized by relational disparity under California law, the impermissibly unreasonable transgressions of binding promises under Montana law or the manifest abuses of right and the immoral and anti-social acts covered by articles 19 and 21 of the Philippine Civil Code.

B. Prospects For The Future

Lender liability, as the inquiry demonstrates, is not incompatible with the legal system in the Philippines. Virtually all the socio-economic determinants which gave rise to it in the various jurisdictions of the United States obtain as well in the Philippines. The unique features of this system -- its accomodation of the civil and common law traditions and its peculiar concept of tort -- furnish a normative matrix in which lender liability can flourish. Moreover, in the same manner that similar developments in the United States have transformed contract law, shifts in the Philippine juristic firmament favoring the tempering of individualism with altruism have weakened the sway of contractual autonomy. These changes promote a paternalistic and facilitative judicial bias in the adjudication of contract disputes so conducive to the rise of lender liability. In particular, the concepts of bad faith breach as a theory of lender liability in the jurisdictions of California and Montana have their Philippine analogues in articles 19

297 *Id.*

298 *Id.*

299 Mueller, *supra* note 143, at 838.

and 21, construed in conjunction with articles 1159 and 1315, of the Philippine Civil Code. With doctrinal parameters broader than those of the former, these analogues provide a window through which California and Montana ratiocinations of the theory can be internalized; or, equally plausibly, they constitute a framework for the parallel development of a Philippine variant of lender liability with its own unique features. *Velayo* and *Development Bank* may well be the harbingers, foreshadowing the emergence of lender liability in the Philippines in the not-too-distant future. Time, not possibility, is the only unsettled question.