

LENDER BEWARE:
Construction Lending and the “Assumed Duty Doctrine”

In an ideal construction scenario, the lender disburses funds to the builder in necessary increments, which the builder then uses in pursuit of an adequate and timely completion of the project. In the end, the buyer is pleased with a project that has been completed on time and within budget. In turn, the lender is happy, the contractor is happy . . . all is well with the world!

Unfortunately, this is not how many construction projects unfold. Myriad problems commonly arise in a typical construction setting, from inadequacies in workmanship or materials, to lack of timely completion. When things inevitably do go awry, many buyers often seek to hold construction lenders liable for inadequate or incomplete construction—particularly when the builder has financial difficulties. Lenders everywhere seek to avoid such liability by delegating all conceivable duties by contract terms, including integration and merger clauses.

One theory used by claimants to circumvent such contract terms and to allege lender liability is a claim for the breach of a lender’s duty to inspect. Other theories include agency, trust, fiduciary duty, implied contract, and other related considerations. *See, e.g., First Nat’l Bank v. Wernhart*, 555 N.W.2d 819 (Wis. Ct. App. 1996); *M.S.M. Corp. v. Knutson Co.*, 167 N.W.2d 66 (Minn. 1969). Under this theory, the claimant generally alleges that the lender breached its duty to inspect the project before disbursing funds to the builder in order to insure that the builder is indeed using the funds in an appropriate manner. *See, e.g., Casey v. Hibernia Corp.*, 709 So. 2d 933 (La. Ct. App. 4th Cir. 1998). At first glance, this allegation seems misplaced, because most lenders either expressly or impliedly do not contractually take on the duty to inspect. In fact, the prudent lender includes provisions in the contract expressly

disclaiming any duty to inspect. But even if the agreement is silent on the matter, most jurisdictions have held that a lender only has the duty to fulfill the specific promises it makes in the written agreement. In other words, if a lender does not contractually promise to inspect the project before disbursing funds, then it is generally under no legal duty to inspect. *See, e.g., Butts v. Atlanta Fed. Sav. & Loan Ass'n*, 262 S.E.2d 230 (Ga. App. 1979); *Henry v. First Fed. Sav. & Loan Ass'n*, 459 A.2d 772 (Pa. Super. 1983); *Lomax v. Headley Homes*, 1997 WL 269432 (Tenn. Ct. App. 1997); *Daniels v. Army Nat'l Bank*, 822 P.2d 39 (Kan. 1991); *Meyers v. Guarantee Sav. & Loan Ass'n*, 144 Cal. Rptr. 616 (Cal. Ct. App. 1978); *Davis v. Nevada Nat'l Bank*, 737 P.2d 503 (Nev. 1987).

Sometimes, however, the lender or its agent orally promises to inspect the project. In most cases, these promises mean little in the way of lender liability, as all states make it difficult for a claimant to recover from a lender on the basis that the lender allegedly made an oral representation that either is not also included in the contract, *see, e.g., Casey*, 709 So. 2d at 933 (holding that because purchasers could not identify any specific document containing an agreement to inspect, the lender was under no duty to inspect); *Butts*, 262 S.E.2d at 230 (holding that an oral promise made by the lender to the effect that all construction work would be checked for good workmanship before any disbursements were approved, which was made before the signing of the loan agreement, constituted parole evidence, thus estopping the buyers from claiming that the lender's assurance enabled them to rely upon the lender's inspection of the construction for their benefit), is materially different from the written contract term, or made prior to the execution of the written contract. *See, e.g., Foremost Ins. Co. v. Parham*, 693 So. 2d 409 (Ala. 1997) (noting that it is not reasonable for a contracting party to rely upon a pre-formation oral representation which contradicts the written document). However, lying dormant

is a potent basis for liability to the lender for such an alleged oral representation: the “assumed duty doctrine.” *See* Restatement (Second) of Torts §§ 323, 324A.

The “assumed duty doctrine” arises from Sections 323 and 324A of the Second Restatement of Torts. *Id.* Under Section 323,

One who undertakes, gratuitously or for consideration, to render services to another which he should recognize as necessary for protection of the other’s person or things, is subject to liability to the other for physical harm resulting from his failure to exercise reasonable care to perform his undertaking, if

- (a) his failure to exercise such care increases the risk of such harm, or
- (b) the harm is suffered because of the other’s reliance upon the undertaking. Restatement (Second) of Torts § 323. *See also* Restatement (Second) Torts § 324A, which applies this same duty to those who undertake to render services to another necessary for the protection of a third person.

The “assumed duty doctrine” potentially creates liability for failure to reasonably perform a duty that does not exist by contract, but which the lender has assumed through its actions. *See, e.g., Rudolph v. First Southern Fed. Sav. & Loan Ass’n*, 414 So. 2d 64, 71 (Ala. 1982) (noting that “one who volunteers to act, though under no duty to do so, is thereafter charged with the duty of acting reasonably, and is liable in damages for injury resulting from a breach of that duty”). In other words, as the name implies, the “assumed duty doctrine” refers to a situation in which one party undertakes a duty that did not previously exist; that duty, once assumed, must be performed reasonably or liability may result. *Rudolph*, 414 So. 2d at 67 (quoting Restatement (Second) of Torts § 324A); *see also Commercial Union Ins. Co. v. DeShazo*, 845 So. 2d 766, 768 (Ala. 2002). The doctrine is most easily understood by examining the legal duties imposed upon the classic Good Samaritan.

In Sunday school, we are taught to step out of the line of passers-by and tend to a stranger in need of aid. Luke 10:25-33. In law school, however, we are taught to tend the stranger reasonably or else the stranger may sue us! For in the eyes of the law, it is worse to negligently tend to the stranger and worsen his condition than to simply leave him alone in the first place.

Alabama's take on the "assumed duty doctrine" shows just how detrimental this doctrine can be to a construction lender. For years, Alabama was one of the premier creditor battlegrounds. Verdicts from rural Alabama juries made national headlines and escalated until they reached mythical proportions. Just as in several other states, local businesses fled Alabama in droves, seeking greener—and safer—pastures. Out-of-state concerns crossed Alabama off their lists of new markets to penetrate.

Fortunately, positive changes in the law improved the business climate for creditors in such states during recent years. The overall economy may be down, but so is the threat of a runaway jury. As a result, commercial lenders and other creditors suffer less legal exposure and enjoy greater stability.

However, courts remain a potentially dangerous place for commercial lenders. This is especially so for construction lenders (residential or commercial) that run afoul of the "assumed duty doctrine." In the construction lending context, the "assumed duty doctrine" can be summed up by a familiar, simple phrase: Loose lips sink ships!

To explain, virtually every state defines the creditor-debtor relationship as being at "arm's length." This generally means that, absent special circumstances, a creditor owes its debtor only those duties that are contained in the documents forming the contractual basis of the creditor-debtor relationship. *Rudolph*, 414 So. 2d at 71. Accordingly, the rights and duties of

the creditor and debtor are determined by the parties' performance of the obligations arising from the contracts and related documents. *Id.*

Therefore, contracting parties must take utmost care to read, understand, and abide by the terms of their contractual agreements. The Alabama Supreme Court underscored these burdens by holding that Alabama law presumes a contracting party will read and understand contract terms prior to signing the contract. *Green Tree v. White*, 719 So. 2d 1179 (Ala. 1998). After signing the contract, the contracting party will be bound by its terms. *Id.* This is true even if the claimant contends he did not read the contract before signing it, and even where he was *illiterate* when he executed the contract. *Id.* at 1180 (quoting *Power Equipment Co. v. First Alabama Bank*, 585 So. 2d 1291, 1296 (Ala. 1991)).

In response to these creditor-friendly legal principles, Alabama debtors often claimed that they were duped into signing the agreement by a contrary oral representation. A seminal decision—*Foremost Ins. Co. v. Parham*, 693 So. 2d 409 (Ala. 1997)—helped put a stop to such fraud claims. The *Foremost* decision changed Alabama's fraud standard from "justifiable reliance" to "reasonable reliance." *Id.* at 421. In so doing, the *Foremost* Court held that it is not reasonable for a contracting party to rely upon a pre-formation, oral representation which contradicts the written document. *Id.* at 421-22.

In practical terms, the *Foremost* decision addressed the situation where one contracting party sued the other party for representing a contract term as "white" when the contract clearly states that the same term is "black." Because Alabama law presumes that the complaining party read and understood those contract terms prior to signing the contract, then the alleged reliance was simply not reasonable in the eyes of the law. *Id.*

These legal principles illustrate the positive changes that helped to improve the commercial and business climate in states such as Alabama. However, lenders are not completely insulated from liability. This is especially so in the construction lending arena, where a lender can unwittingly run afoul of the “assumed duty doctrine.” Such an assumed duty might expose the lender to liability for failing to reasonably perform a duty that does not arise by the contract alone. Thus, the “assumed duty doctrine” could result in liability to a lender for *negligence* even where no breach of contract claim exists.

Such was the case in *Rudolph v. First Southern Federal Savings & Loan Association*, 414 So. 2d 64 (Ala. 1982). where the Rudolphins took out a construction loan with their lender. *Id.* at 64. As in most construction lending transactions, the *Rudolph* loan documents did not obligate the lender to perform construction inspections. *Id.* at 64-65. The documents further stated that if the lender chose to perform such inspections, the inspections would be for the lender’s benefit. *Id.* Additionally, the borrowers had no right to rely on the bank continuing to perform inspections, or on what the inspections themselves revealed. *Id.* at 65.

Thus, no duty to inspect arose from the *Rudolph* contract documents. However, a lender representative admitted that at a meeting before the contracts were signed, he told the borrowers that the lender *would* perform inspections. *Id.* He assured the borrowers that they could rely on those inspections, eliminating the need for the borrowers to engage an independent inspector. *Id.* at 65-66. Thereafter, the lender failed to perform adequate inspections, and the loan became over-disbursed in relation to the percent of adequate and completed construction. *Id.* at 65. The borrowers sued the bank. *Id.*

At trial, the lender argued that the contractual documents governed the rights and liabilities of the parties. Those documents, the lender concluded, did not obligate the lender to perform inspections. *Id.* The court held that absent the oral representations by the loan officer, the lender would have defeated the borrower's negligence claim, because no duty to inspect arose from the contract documents. *Id.* at 70-71. The court further held that the lender's failure to inspect was not a breach of contract for that same reason: There was no contractual duty to inspect. *Id.* at 71.

However, the *Rudolph* court also held that the lender had voluntarily assumed a duty to inspect through its agent's admitted oral representations. *Id.* In addition, although ordinary lender-performed inspections would solely benefit the lender (as is true in almost all construction loan documents, including those at issue in the *Rudolph* case), the court held that the representations by the loan officer in *Rudolph* were clearly made for the *borrowers'* benefit. *Id.* If the lender makes promises to inspect that are not for the benefit of the borrower, then there is no assumed duty. The *Rudolph* court explains:

[N]o duty is imposed upon a lender of a construction loan to exercise reasonable care in its inspection of the borrower's premises, even where the borrower pays the lender's inspection fee, unless the lender voluntarily undertakes to perform such inspection on behalf of and for the benefit of the borrower. The mere relationship of lender, borrower, including the lender's right of inspection at the borrower's cost does not, of itself, give rise to a duty of due care to the borrower in the lender's exercise of that right.

Id. at 71.

Additionally, the claimant has the burden of showing that the lender made its promise to inspect for the claimant's benefit:

Because the lender may exercise his independent right of inspection for its exclusive benefit, and thus incur no liability to the borrower for its negligent inspection, the burden is on the borrower, seeking to impose liability, to prove the lender's voluntary assumption of activities beyond those traditionally associated with the normal role of a money lender. This burden of proof is met only when

the evidence reasonably supports an inference of fact to the effect that the lender, either affirmatively or through a course of conduct, assumed the function of inspection expressly, though not necessarily exclusively, for the benefit of the borrower.

Id. See also *Manstream v. United States Dept. of Agriculture*, 649 F. Supp. 874 (11th Cir. 1986) (holding the same). Thus, the bank was liable to the borrowers for negligently failing to perform inspections after it had assumed the duty to do so. *Id.* at 71-72.

The *Rudolph* case is but a single example of loose lips sinking ships. The *Rudolph* contract terms were designed to protect the lender from the very liability it ultimately faced. However, those contract terms took a legal backseat to what were no doubt well-intentioned, but uninformed attempts by a loan officer to aid his borrowers and close the deal.

The good news for construction lenders is that few courts have applied the “assumed duty doctrine” in this way. This is especially so where, as was true in *Rudolph*, the oral representation was made before the execution of the written contract. When faced with similar situations, other jurisdictions have refused to consider *any* promises made outside the explicit terms of the contract through use of the parol evidence rule; (The “parol evidence” rule is a rule of contract interpretation and evidence stating that if a contract is clear and unambiguous on its face (i.e., if the court can clearly interpret the contract using just the terms contained in the agreement) then any agreements or promises made outside of the written contract will not be considered in interpreting the document. See 17A Am. Jur. 2d *Contracts* § 197 (1991)) thus effectively extinguishing a potential “assumed duty” attack on the lender. See, e.g., *Lassiter v. Bank of North Carolina*, 264 S.E.2d 920 (N.C. App. 2001); *Butts v. Atlanta Fed. Sav. & Loan Ass’n*, 262 S.E.2d 230 (Ga. App. 1979); *Henry, supra*; *Charter One Bank v. Hamburger*, 2002 WL 252382 (Ohio App. 6 Dist. 2002).

For example, the Georgia Court of Appeals held in *Butts v. Atlanta Federal Savings & Loan Association* that a lender's oral promise, made before the signing of the loan agreement, to check all construction work for good workmanship before it approved any disbursements constituted "parol evidence," thus preventing the buyers from claiming that the lender took on an "assumed duty" to inspect. 262 S.E.2d at 231. *See also Lassiter*, 264 S.E.2d at 922-23 (holding the same). *But see First Nat'l Bank v. Wernhart*, 555 N.W.2d 819 (Wis. Ct. App. 1996) (holding that In connection with a project in which mortgagors had contracted with general contractor for construction of a dwelling for them, mortgagee bank's failure to inspect property until after it disbursed \$40,000 in mortgage proceeds and \$15,000 of mortgagors' personal funds to general contractor, or to take other precautions when distributing funds to assure reasonable compliance with construction contract, was breach of its fiduciary duty to mortgagors, resulting in its liability to them as to payments made under circumstances where contractor had not completed sufficient work to warrant them). The buyers obtained a home construction loan from a savings and loan association, and after becoming dissatisfied with the contractor's work, filed suit against the lender when the contractor filed for bankruptcy, arguing that the lender improperly paid out funds to the contractor without an inspection, which could have shown that the work was defectively performed. *Butts*, 262 S.E. 2d at 231. The buyers claimed that the lender assured them that the construction would be approved for good workmanship before funds were disbursed to the contractor. *Id.* The court, however, stated that any oral promises made prior to the signing of the loan agreement were inadmissible to add to, take from, or vary the terms of the contract. *Id.* at 232. Therefore, because the lender made no express promise to inspect in the written agreement, the court held that the buyers could not claim any reliance on the lender's promise to inspect the construction. *Id.*

The bad news for lenders, however, is that not many jurisdictions have had an opportunity to rule on similar facts. Including Alabama, courts in at least four states have favorably discussed attaching liability to a lender for assuming a duty to inspect and then failing to satisfy that duty: Alabama (*Rudolph, supra*); Florida (*Kalbes v. California Fed. Sav. & Loan Ass'n*, 497 So. 2d 1256 (Fla. Dist. Ct. App. 1986); *Saglio v. Chrysler First Commercial Corp.*, 839 F. Supp. 830 (M.D. Fla. 1993)); Pennsylvania (*Henry, supra*); and Tennessee (*Lomax, supra*). If the parol evidence rule is not available as a viable defense—because the alleged oral representation occurred after execution of the written agreement or otherwise—then the Restatement’s embodiment of the assumed duty doctrine exists as potent means of attaching lender liability in most every jurisdiction. Thus, it is clear that *Rudolph* serves as a broader example of the pitfalls that can befall a lender when, through words or actions, the lender assumes a duty that did otherwise exist by contract. This is especially so where, as is true in Alabama, evidence supporting a claim of fraud may be admissible to defeat a parol evidence defense. *Lloyd Noland Foundation, Inc. v. City of Fairfield Healthcare Authority*, 837 So. 2d 253, 266 (Ala. 2002).

Let’s face it, when all is said and done, lenders remain a favorite target for plaintiffs’ counsel—after all, it’s where the money is! Therefore, as our colleagues on the other side of the bar are focusing on this fertile field of recovery, it would be wise to take stock in your lending clients’ documents and consult your jurisdiction’s laws on this topic. In fact, it may be worthwhile to minimize your clients’ risk of exposure by taking some preventative measures and advising them on the dangers of the “assumed duty doctrine.” Because, as we have seen, if the “assumed duty doctrine” applies, failure to perform that duty can negate careful drafting and

result in legal exposure even in today's favorable business climate. The moral of this story is clear: Lender Beware.



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