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As Seen In Law360 April 26, 2017

In New York Lending Agreements, The Contract Rules

Lenders should make one change to their loan documentation: where possible, add a New York choice-of-law provision. In some states, borrowers may invoke the "implied covenant of good faith and fair dealing" to circumvent certain express loan terms. New York's First Department recently made clear that such arguments by the borrower will be rejected.

The First Department's Decision on the Implied Covenant of Good Faith and Fair Dealing

In Transit Funding Associates LLC v. Capital One Equipment Finance Corp., 48 N.Y.S. 3d 11, 2017 N.Y. App. Div. LEXIS 1506 (1st Dep't 2017), the borrower entered into a commercial loan agreement that ultimately established an $80 million line of credit. The loan agreement provided that Capital One, the lender, would make advances to TFA, the borrower, "in such sums as TFA may request," but gave Capital One the complete authority to decide whether to advance funds. In particular, the loan agreement provided:

> Notwithstanding anything to the contrary contained herein, [Capital One] reserves the right to make or decline any request for an Advance in its sole and absolute discretion and may condition the availability of an Advance upon, among other things, (i) that no Default or Event of Default occurring hereunder or under any Loan Documents exists and continues beyond the expiration of application notice and cure periods; or (ii) the maintenance of a satisfactory financial condition by [TFA] and all Guarantors; or (iii) for any other reason determined by [Capital One] in its sole and absolute discretion. (emphasis added)

Before expiration of the loan agreement, Capital One abruptly began denying all loan advances, regardless of creditworthiness. TFA alleged that Capital One did so because Capital One was collaborating with a competitor of TFA. TFA commenced an action for breach of the loan agreement, breach

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of the implied covenant of good faith and fair dealing, breach of fiduciary duty, fraud and related claims.

At the trial level, Capital One moved to dismiss the complaint in its entirety. The trial court dismissed the noncontract claims but declined to dismiss the claims for breach of the loan agreement, breach of the implied covenant of good faith and fair dealing, and declaratory judgment. Both the lender and the borrower appealed the trial court's ruling.

On appeal, the First Department upheld the trial court's dismissal of the noncontract claims, but modified the trial court's decision to dismiss all of the remaining claims and to declare in Capital One's favor with respect to liability under the loan agreement. In strictly enforcing the language of the loan agreement, the First Department held:

> In view of the provisions of the loan agreement expressly allowing Capital One to deny any requests for advances in its "sole and absolute discretion," and specifically authorizing Capital One to deny any such requests for any reason, it cannot be said that Capital One violated the contract by failing to advance funds as requested, even if that decision put TFA out of business.

The First Department acknowledged that all contracts imply a covenant of good faith and fair dealing in the course of performance, but declared that, "The covenant of good faith fair dealing cannot negate express provisions of the agreement, nor is it violated where the contract terms unambiguously afford Capital One the right to exercise its absolute discretion to withhold the necessary approval."[1] The First Department also noted that other provisions in the loan agreement limited the ability of Capital One to exercise unfettered discretion, but that the advance provision lacked any such limitation, thereby showing that the parties intended to allow Capital One the ability unilaterally not to make an advance for any reason.

Key Lessons From the First Department's Recent Holding

There are five takeaways for lenders from this recent decision:

***Add a New York Choice-of-Law Provision*.** Not all states concur with New York's First Department. By way of example, New Jersey's Supreme Court has permitted claims for breach of the implied covenant even where a contract expressly allows one party to act with unfettered discretion. See Brunswick Hills Racquet Club Inc. v. Route 18 Shopping Center Associates, 182 N.J. 210 (2005). Thus, in New Jersey, a borrower could claim that a lender breached the implied covenant of good faith — notwithstanding an express provision like the one considered by the First Department — where allowing the lender to act would deprive the borrower of the "fruits" of the loan agreement. Sons of Thunder Inc. v. Borden Inc., 148 N.J. 396, 420 (N.J. 1997). Therefore, inserting a New York choice-of-law provision into the loan agreement will allow a lender to take advantage of New York's more limited view of the implied covenant of good faith and fair dealing.

***Add a New York County Sole and Exclusive Jurisdiction Provision*.** New York, unlike other states, has four appellate divisions, covering different geographic areas. The First Department covers the trial courts in New York County and

Bronx County. Therefore, a trial court in, say, Albany would not necessarily feel bound by a First Department decision. In order to ensure that the case is filed in a court subject to First Department jurisdiction, it is best to insert a jurisdiction provision that limits the "sole and exclusive" venue to the Supreme Court of New York or Bronx County.

Clarify the Language in Your Loan Documents. It is good practice to take language approved by the court in one case and apply it to your own loan documents. Here, the First Department approved the language, "Notwithstanding anything to the contrary contained herein, [Lender] reserves the right to make or decline any request for an Advance in its sole and absolute discretion and may condition the availability of an Advance upon, among other things ... for any other reason determined by [Lender] in its sole and absolute discretion." Similar language should be in a lender's loan documents where the lender wants to have unfettered decision-making capability.

Make Clear Where the Lender Does Not Have Unfettered Discretion. The First Department noted that other provisions in the loan documents limited the lender's discretion, which by implication meant that the parties understood and intended to limit discretion in certain situations and not impose limits as to other provisions. Where warranted, limiting discretion on certain provisions, while retaining unfettered discretion for other, more key provisions, will make the loan documents closer to what the First Department approved.

Confirm the Lenders Unfettered Discretion Even When Agreeing to a Borrower's Request. For example, if the loan documents allow the lender unfettered discretion on an advance, the lender may well decide to agree to a borrower's request for an advance. When communicating about the advance — whether in e-mail or formal writing — the lender should expressly remind the borrower that the lender is granting the advance request "in the lender's sole and absolute discretion" and cite to the loan agreement provision giving such unfettered discretion. This will make it harder for a borrower to claim that the lender was somehow foregoing or waiving its "sole and absolute discretion."

In sum, the goal of a good loan agreement is to make clear the rights of both parties, so that litigation can be avoided (or, if not avoided, resolved via a motion to dismiss or motion for summary judgment). Taking the above steps will reduce the risk of litigation down the road, and put the lender in a position to enforce the loan agreements as the lender intended.

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[1] *One trial court has followed the First Department's holding that the implied covenant of good faith cannot negate an express contractual provision. See Ferreira Construction Co. v. City of New York, Department of Transportation, 2017 N.Y. Misc. LEXIS 824 at *10 (Supreme Court, N.Y. County 2017).*