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The Pitfalls of Drafting Preliminary Loan Documents

As the frozen credit environment slowly begins to thaw, thoughts in the real estate finance world turn to newly issued loan commitments and term sheets. Since many potentially active mortgage lenders have not issued a commitment letter or term sheet for several years or are newly formed companies founded since the inception of the credit crisis, counsel representing such lenders should be mindful of certain pitfalls associated with such preliminary documentation, including the potentially binding nature thereof. Even as term sheets and commitment letters typically anticipate the execution of definitive loan documentation at the later closing of the transaction, courts have found, in certain circumstances, that such preliminary agreements are binding upon the parties thereto, and therefore, a lender may be obligated to make the contemplated mortgage loan regardless of the ultimate desire of the lender.

It is a well established tenet of contract law that even in the absence of a final written agreement, preliminary documentation that sets forth the material terms of the bargain may bind the parties thereto.¹ In New York, both federal and state courts have agreed that the most important factor in distinguishing a binding preliminary agreement from a non-binding expression of interest is the intention of the parties at the time of their entry into the understanding. The analysis used by New York State courts and federal courts to consider the issue of the parties' intent, however, may differ. Consequently, the determination of whether a preliminary agreement between a borrower and mortgage lender, such as a term sheet, memorandum of understanding or commitment letter, has a binding effect may depend on where the case is filed.

Federal courts have followed the analysis first articulated in *Teachers Ins. & Annuity Ass'n of America v. Tribune Co.*² In *Tribune*, a commitment agreement stated that the borrower and lender had made a "binding agreement" to borrow and to lend on the agreed terms, subject to the preparation and execution of final documents satisfactory to both sides and the approval of the borrower's board of directors. The borrower then broke off negotiations and declined to negotiate further. In determining whether the commitment letter was binding, Judge Pierre N. Leval noted that there are two types of potentially binding preliminary agreements, Type I and Type II. As set forth in *Tribune*, to find a Type I agreement the court will consider: (1) whether the agreement sets



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forth the essential terms of the transaction; (2) whether there has been partial performance; and (3) industry custom and practice. If a preliminary agreement is found to be Type I, the parties will be bound by its terms as



though it were a final contract. A Type II agreement, on the other hand, would require the parties to further negotiate, in good faith, a final contract based on the terms expressed in such preliminary documentation. Neither party to a Type II agreement, however, may demand performance of the transaction in question, only good faith negotiation.³ In making a determination if such an agreement is Type II, the court will consider: (1) the context of the parties' negotiations; (2) the existence of the open terms; (3) the customary form of documents for the contemplated transaction; and (4) whether there has been partial performance. Using this analysis, the court in *Tribune* held that even though

countless pages of relatively conventional minor clauses had yet to be agreed upon, both sides were obligated to negotiate final loan documents consistent with the previously agreed terms and provisions and to resolve, in good faith, such additional terms as are customary in such agreements.

There is a recent movement in New York State courts to reject the federal Type I/Type II classifications as too rigid. In *IDT Corp. v. Tyco Group*,⁴ the New York Court of Appeals held that a preliminary settlement agreement was not binding when it contemplated the occurrence of numerous conditions, including the negotiation and execution of four additional agreements, most important of which was the negotiation and execution of an "indefeasible right of use" of certain fiber optic capacity on a planned subsea cable system. The court held that the settlement agreement never became binding because the agreed-upon conditions had not been met and "the consummation of those agreements was a precondition to a party's performance." In rendering its decision, the court did not consider certain federal Type I/Type II factors, such as the customary form of documents for the contemplated transaction nor whether there had been partial performance. While not concerning a real estate loan, *Tyco* is an important decision in the analysis of the potentially binding nature of a mortgage term sheet, commitment letter or other preliminary agreement. In addition to *Tyco*, other courts have likewise questioned the Type I/Type II analysis and its applicability to New York contract law.⁵

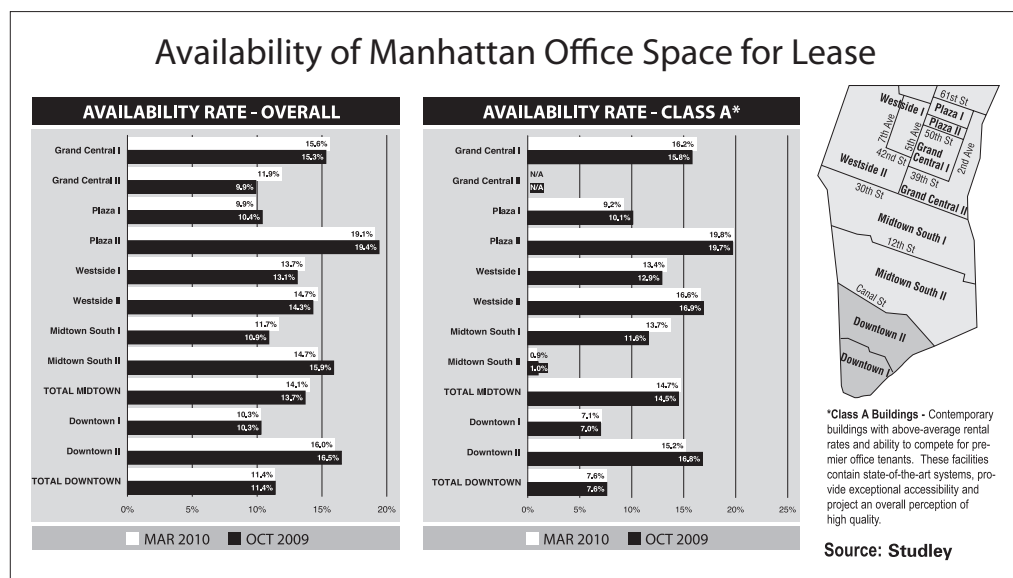
After the *Tyco* decision was rendered in October 2009, many questioned whether other New York State courts would overtly reject the federal Type I/Type II classification. On Feb. 4, 2010, the answer became clear. In *Amcan Holdings Inc. v. Canadian Imperial Bank of Commerce*,⁶ the Appellate Division found the federal Type I/Type II analysis was not helpful in determining whether a preliminary agreement that contemplated the negotiation of later agreements was binding. There, the preliminary agreement stated that "[t]he Credit Facilities will only be established upon completion of definitive loan documents, including a credit agreement...which will contain the terms and conditions set out in this Summary in addition to such other representations... and other terms and conditions... as [the lender] may reasonably require." The court in *Amcan Holdings* reasoned that the preliminary agreement was clearly dependent on a future definitive agreement and the parties did not explicitly state that they intended to be bound by the preliminary agreement. The court granted the motion to dismiss the complaint and did not consider the other factors first articulated in *Tribune* and applied by both federal and state courts for more than 20 years.

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New York State courts appear to give more weight than the federal analysis to the plain language of a preliminary agreement and are less concerned with other factors.⁷

A crystal clear statement of the intent not to be bound that is included in a term sheet or other preliminary agreement should be sufficient to avoid unintended consequences, even against a claim of promissory estoppel or detrimental reliance. Under New York law, the elements of a promissory estoppel claim require the injured party to demonstrate that there was a “clear and unambiguous promise” on which it relied to its detriment and that such reliance was foreseeable to the promisor. In *In re 50 Pine Co., LLC*,⁸ the plaintiff alleged that in connection with its execution of a contract of sale to purchase certain real estate it relied, to its detriment, on a term sheet issued by a prospective lender and therefore it did not seek out other financing alternatives. The plaintiff further alleged that because the lender refused to lend the money, the plaintiff had no meaningful choice but to file for Chapter 11 protection in order to protect its down-payment. The subject term sheet specifically stated that “[t]his Term Sheet is for discussion purposes only. This is not a commitment to extend credit in any form and remains subject to due diligence, credit approval and documentation.” The court held that this language clearly showed that the parties did not intend to be bound by the term sheet and there was no “clear and unambiguous promise” and thus the plaintiff did not have viable claim sounding in promissory estoppel. In short, the fact that a potential borrower detrimentally relies on a term sheet and forgoes other financing opportunities would not factor into a court’s finding when the intent not to be bound is clear by the provisions contained in the preliminary agreement.

While a claim of promissory estoppel or detrimental reliance will likely not change a court’s interpretation of the non-binding nature of a subject preliminary instrument containing unambiguous language, subsequent verbal assurances may factor into a court decision about the intent of the parties. Even when such preliminary agreement states that it is subject to the completion of satisfactory due diligence and contemplates the negotiation of later agreements, the parties should still be cautious as ensuing oral agreements may be relied upon and, as such, sway a court’s decision. In *Crossroads Mortgage Corp. v. Columbia Equities Ltd.*,⁹ the Court found that a verbal statement made after the execution of a letter of intent may make such preliminary agreement binding and dismissed the defendant’s motion for summary judgment. There, the parties entered into a seven-page letter of intent for the acquisition of the plaintiff by defendant, which indicated that the consummation of the contemplated transaction was “subject to due diligence which, among other things, shall include satisfactory review by [the defendant] of financial statements and tax returns, as well as other reports and information as reasonably requested.” Upon the completion of its due diligence, an officer of the defendant telephoned the plaintiff to confirm that it had “passed” the defendant’s due diligence review, that he “had a check in his pocket” for the agreed purchase price and that the acquisition was a “done deal.” In reliance upon the verbal statements, the plaintiff ceased negotiating with other potential buyers, among other things. When the defendant eventually backed out of the transaction, the plaintiff commenced its action. Even though the preliminary agreement was only a letter of intent (and not a fully negotiated or, on its face, a binding contract of sale) containing certain requirements and conditions precedent to closing, the subsequent oral communication between the parties was



sufficient for the plaintiff to assert detrimental reliance and defeat a motion for summary judgment in its claim that the preliminary letter of intent was binding.

Mortgage loan term sheets and commitment letters frequently contain language stipulating that the lender’s obligation to proceed with making the subject loan remains, inter alia, subject to the approval of its internal

With the recent increase in the issuance of mortgage loan term sheets and commitment letters, lenders would be prudent to recognize the potentially binding nature of such agreements and to take steps to prevent themselves from being unintentionally obligated to close. Drafting clear language in the preliminary documentation and the avoidance of confusing subsequent modification, whether oral or written, should be sufficient for a court to correctly infer a lender’s intent not to be bound and enforce such terms.

Even as term sheets and commitment letters typically anticipate the execution of definitive loan documentation at the later closing of the transaction, courts have found, in certain circumstances, that such preliminary agreements are binding upon the parties thereto, and therefore, a lender may be obligated to make the contemplated mortgage loan regardless of the ultimate desire of the lender.

credit committee. Although there is almost no case law directly on point, it is likely that a court would require a lender to use good faith efforts to obtain such approval. In *Zuker v. General Electric Capital Corp.*,¹⁰ a forbearance/settlement agreement between a mortgage lender and its borrower required the review and approval of the lender’s internal credit committee before it became obligated thereunder. The lender was alleged to have assured the borrower that committee approval was simply a formality and as such, the borrower performed certain conditions precedent, the benefits of which were accepted by the lender “even while knowing that the credit committee had no intention of approving the deal.” The borrower further alleged that the lender “decided to use credit committee disapproval as a pretext to obtain consideration not contemplated by the parties in the settlement agreement.” When the lender walked away from the deal set forth in the forbearance/settlement agreement, the borrower filed suit. The court dismissed the lender’s motion for summary judgment and indicated that one party cannot lull the other party into believing that the approval of its credit committee was a mere institutional formality, benefit from that assertion, and then claim it was never obligated to close.

1. *Brown v. Cara*, 420 F.3d 148, 154 (2d Cir. 2005).
2. 670 F.Supp. 491, 498 (S.D.N.Y. 1987).
3. *Rubinstein v. Clark & Green Inc.*, 2010 WL 298239 (N.D.N.Y. 2010).
4. 13 NY 3d 209, 213 n. 3 (2009).
5. *Fairbrook Leasing Inc. v. Mesaba Aviation Inc.*, 519 F.3d 421, 426 (8th Cir. 2008) (the Eighth Circuit questioned the Type I/Type II dichotomy and that it had not found any New York appellate decisions enforcing a “Type I” preliminary agreement).
6. 894 N.Y.S.2d 47 (1st Dept., 2010).
7. On Jan. 19, 2010, in *Rubinstein*, the federal court still applied the Type I/Type II classification in analyzing whether a preliminary agreement was binding.
8. 317 B.R. 276, 283 (Bankr. S.D.N.Y. 2004).
9. 1997 WL 363809 (S.D.N.Y. July 1, 1997).
10. 20 F.Supp.2d 254 (D.Mass. 1998).