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Accommodating Struggling Borrowers: No Good Deed Goes Unpunished

In the current economic climate, lenders continue to face the Hobson's Choice of how to respond to once-reliable borrowers who are now showing signs of distress.

For example, when a borrower fails to make a monthly interest payment, or fails to adhere to other requirements under a loan agreement, a lender has the option of noticing a default, which, if uncured, allows the lender either to accelerate the loan at issue or foreclose on the underlying collateral (e.g., typically, the property in a real estate lending context). However, if, as is often the case, the loan is non-recourse (except for "bad act" carveouts), or if the property has significantly diminished in value since the execution of the loan documents, a lender might opt to accommodate a delinquent borrower rather than pursuing foreclosure. Lenders who pursue this strategy, however, must be cautious.

Indeed, under recent case law, a lender who defers acceleration or other enforcement rights upon the occurrence of an "event of default" might be deemed to have modified or waived certain rights under the original loan documents at issue, even if these underlying documents contain "no waiver" or "no oral modification" provisions. However, recent cases demonstrate that lenders can protect their rights while accommodating distressed borrowers by properly notifying these borrowers that the terms of the original loan documents remain in effect.

As a general rule, New York State law prohibits oral modifications of written contracts where the contract itself contains language expressly precluding such changes. N.Y. Gen. Oblig. Law §15-301. Notwithstanding this general rule, there are limited instances in which a borrower can argue that its contractual



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obligations were changed pursuant to an oral modification of the loan agreement or that the lender waived its right to enforce, or is estopped from enforcing, the original contract terms. These arguments often are premised on similar facts and usually are asserted in tandem.

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Oral Modifications

It should be noted that, in determining whether an oral modification has occurred, courts typically look to the conduct of the borrower. A borrower can argue that a loan agreement was orally modified under New York law if the borrower engaged in conduct that was "unequivocally referable" to the alleged modification (i.e., incompatible with the terms of the original agreement), and if this conduct benefited the lender. *Club Haven Inv. Co., LLC v. Capital Co. of America, LLC*, 160 F. Supp.2d 590, 592 (S.D.N.Y. 2001) (citations omitted). Consequently, if a lender forbears from enforcing certain of its rights under a loan agreement in order to afford the borrower more time to fulfill its obligations, the borrower might later contend that the lender's forbearance, or the borrower's noncompliance with certain

terms without the lender consequently enforcing its rights, demonstrates that the original agreement was modified.

In cases in which an oral modification defense is invoked, the threshold issue is whether the borrower's noncompliance deviated enough from the original agreement so as to be "unequivocally referable" to the alleged modification.

In one recent case in the Southern District of New York, the loan agreement at issue required the borrower to procure comprehensive insurance coverage for the property that was pledged as collateral for the loan at issue. *BA Chub Cay, LLC v. McCrory*, No. 8 Civ. 5217(JSR), 2009 WL 976826, at 1 (S.D.N.Y. April 8, 2009). When the borrower's insurance policies were cancelled, the lender did not immediately exercise its right to accelerate the loan, and instead told the borrower that it might "force" insurance upon it if the borrower did not procure replacement insurance. The lender ultimately opted to accelerate the loan two months after the borrower had failed to obtain the requisite insurance.

The court rejected the borrower's argument that the borrower's continued search for additional insurance and the lender's failure to impose "forced insurance" on it constituted an oral modification of the loan agreement's insurance requirements. The court found that the borrower's conduct was not "unequivocally referable" to any such modification and thus granted summary judgment in favor of the lender.

Notwithstanding the favorable ruling in *BA Chub Cay*, to the extent that lenders forbear from exercising their rights under a loan agreement, they should reiterate in written communications with borrowers that any departure from a loan agreement's original terms does not constitute a modification of the agreement or waiver of any rights thereunder.

For example, in *Fairchild Warehouse Assocs., LLC v. United Bank of Kuwait*, 285 A.D.2d 444, 727 N.Y.S.2d 153 (2d Dept. 2001), a borrower contested foreclosure proceedings based on the fact that it had withheld monthly mortgage payments several months before the end of the repayment period, and that it instead had deposited rental income from the property

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into a special account designated for building improvements. The borrower argued that these actions, and the lender's failure to hold the borrower in default until 17 months after the first missed payment, demonstrated that the parties had orally agreed to transform the loan into a cash-flow mortgage. The lender argued that the borrower's conduct was not "unequivocally referable" to the alleged modification and that its own delay was due to extended negotiations intended to assist the struggling borrower.

The court denied the lender's motion for summary judgment and held that the question of whether a modification had occurred was an issue of fact to be determined at trial.

Furthermore, lenders also should be wary of accepting additional consideration from borrowers when deferring or forbearing from enforcing original contract terms. New York law requires that, parties seeking to modify a written contract orally must provide their counterparties with additional consideration. *LaGuardia Assocs. v. Holiday Hospitality Franchising Inc.*, 92 F.Supp.2d 119, 129 (E.D.N.Y. 2000).

For example, when one borrower merely sought to extend the period of repayment on a promissory note, the court held that the additional interest payments due under the purported extension did not constitute additional consideration that would support an enforceable modification. *Fed. Deposit Ins. Corp. v. Hyer*, 66 A.D.2d 521, 529, 413 N.Y.S.2d 939, 944 (2d Dept. 1979). However, if a borrower agrees to pay a higher rate of interest in exchange for the lender's forbearance from accelerating the loan, a court might conclude that the borrower provided sufficient consideration to support an enforceable modification. See *I. Reiss & Son v. Silver Colt Realty Assocs.*, 184 A.D.2d 205, 206, 584 N.Y.S.2d 799, 800 (1st Dept. 1992) (holding that "an increase in interest on the principal amount unpaid and the conveyance of certain property" would constitute sufficient consideration to support a modified agreement).

Ultimately, to safeguard against an "oral modification" defense, a lender must demonstrate, unequivocally, that it did not agree to modify the original contract at issue. In *Southern Federal Savings and Loan Association of Georgia v. 21-26 East 105th Street Associates*, 145 B.R. 375 (S.D.N.Y. 1991), aff'd, 978 F.2d 706 (2d Cir. 1992), a borrower argued that its loan agreement had been modified because the lender had accepted the borrower's partial payments and deducted the shortfall from undistributed proceeds. The court rejected the borrower's argument, however, and held that a course of conduct alone could not alter contractual obligations if the parties did not actually agree to modify the terms of the contract.

Although the lender in that case did not notify the borrower that its forbearance did

not constitute a modification, lenders who do provide such notice will be better able to demonstrate that they did not agree to any modifications and thus that neither their forbearance nor the borrowers' conduct could alter the parties' written (contractual) obligations.

Waiver and Estoppel

In addition to the doctrine of oral modification, borrowers also have invoked the doctrines of waiver and estoppel as a defense to a lender's acceleration or foreclosure on a loan. For example, in *U.S. West Fin. Servs. Inc. v. Marine Midland Realty Credit Corp.*, 810 F.Supp. 1393 (S.D.N.Y. 1993), a borrower was required to submit certain documents to a standby lender, which lender, in turn, was then required to notify the primary lender if the borrower defaulted. The borrower failed to provide the necessary documents on time, but the secondary lender did not exercise its contractual right to declare an event of default or notify the primary lender of this deficiency. The court, using the same analysis applied in modification cases, found there to be an issue of fact as to whether the secondary lender had waived its rights to repudiate its funding obligations based on insufficient documentation. *Id.* at 1406.

A lender's efforts to accommodate a struggling borrower carries with it the risk of an oral modification, waiver or estoppel defense if and when the parties unsuccessfully conclude their negotiations and the lender then opts to exercise its rights.

In the same vein, a borrower's assertion of waiver must meet the "threshold of believability" to forestall foreclosure proceedings. *N.Y. State Urban Dev. Corp. v. Marcus Garvey Brownstone Houses Inc.*, 98 A.D.2d 767, 469 N.Y.S.2d 789, 795 (2d Dept. 1983). A borrower's mere assertion that the lender waived its right to foreclose on a loan, or its uncorroborated affidavits attesting to the waiver, will not prevent a foreclosure. *Sec. Pacific Mortg. and Real Estate Servs. Inc. v. Canadian Land Co. of Am., N.V.*, 690 F.Supp. 1214 (S.D.N.Y. 1988). Further, lenders who notify borrowers that all contractual terms remain in effect while workout provisions are being negotiated can also preserve these rights. *Fed. Home Loan Mortg. Corp. v. 141st Street and Broadway Realty Co.*, No. 92 Civ. 1433 (MBM), 1994 WL 9686 (S.D.N.Y. Jan. 7, 1994).

Finally, a key element in waiver and estoppel case law is the element of reliance. In *Club Haven*, a borrower was unable to close on time

and allegedly obtained an extension from the lender. 160 F. Supp.2d at 592. The court held that this purported extension did not modify the original agreement because it did not inure to the benefit of the lender as required by law. However, because the borrower relied on the extension—expending further resources to close the loan after the original deadline had passed—the court estopped the lender from relying on the "no oral modification" provision contained in the loan agreement at issue.

Conclusion

In sum, a lender's efforts to accommodate a struggling borrower carries with it the risk of an oral modification, waiver or estoppel defense if and when the parties unsuccessfully conclude their negotiations and the lender then opts to exercise its rights. One prudent stopgap measure is for the parties to enter into a pre-negotiation agreement that expressly acknowledges the lender's intent to reserve all its rights under the loan documents and expressly precludes any oral modification, waiver or estoppel defenses to be raised by the borrower. Short of executing this type of an agreement, there also are intermediate steps that can be taken, such as the lender limiting the duration of its forbearance from exercising its rights and repeatedly reiterating a reservation of rights in all communications with the borrower.

Otherwise, courts might construe an extended period of forbearance and no reservation of rights assertion as evidence that a modification occurred or that the borrower justifiably relied on the same. Additionally, lenders should not bargain for reciprocal concessions from borrowers, as courts might find that these concessions constitute sufficient consideration for an enforceable modification. If lenders are clear about their intentions, they can accomplish the dual purpose of accommodating their borrowers while not compromising their own rights and remedies under the loan documents.