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Expert Analysis

Cases Suggest Boundaries To Lenders' Consent Rights


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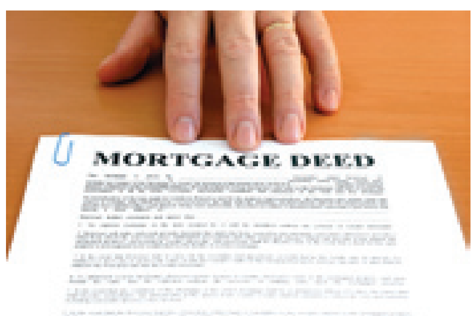
In negotiating commercial mortgage loan documentation, much time and energy is put forth by a borrower's counsel to require the lender to act reasonably in granting or withholding required consents. Obtaining this flexibility is never more important than under CMBS loans, where the ongoing loan administration is handled by a third-party servicer rather than a relationship lender. In recent experience, perhaps due to the aftershocks of the market disruption, lenders (and servicers, as their agents) have become more inflexible in administering consent requests.

As further discussed below, New York courts have historically held that provisions that require a lender's consent to a transfer —without any limitation on such consent—permit lenders to condition their consent upon receiving additional benefits, such as bringing a mortgage loan "up to market." However, the case law suggests that the lenders' consent rights have some boundaries, and even when a lender's consent is subject to a "sole and absolute discretion" standard, New York law imposes limits on the lender's exercise of that discretion. In particular, even where a contract affords a party the right to make a decision in its "sole and absolute discretion," the party's exercise of that discretion is nonetheless subject to an implied duty of good faith and fair dealing, which includes "a promise not to act arbitrarily or irrationally."[1] When a "reasonableness" requirement limits the lender's consent right, courts have generally held that the lender may not impose conditions to bring the loan to market.

In *Bonaday Apartments Inc. v. Columbia Banking Federal Sav. And Loan Ass'n*, 119 Misc.2d 923, 465 N.Y.S.2d 150 (Sup. Ct. Steuben Co. 1983), for example, the court addressed the question of whether a mortgagee was entitled to invoke the acceleration clauses in the bond and mortgage even if the transferee of the subject property had agreed to assume the obligations according to the terms of those instruments. There, the mortgagee had conditioned its consent to transfer the mortgage upon an increase in the mortgage interest rate to the current market rate, to which the transferee had not assented. The mortgage contained a "due on sale" provision which was triggered "if the mortgagor shall convey said premises without the written consent of the mortgagee herein."[2]



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The *Bonaday* court held that, because the clause at issue contained no conditions or restrictions on the bank's right to invoke the clause—in particular no requirement that the bank would "not unreasonably…withhold" its consent—it would not impose any other condition on the bank's consent other than "the condition of good faith and fair dealing implied by law in all contracts."[3] The court then went on to explain that the bank's demand that the transferee pay a higher, market rate of interest in return for the bank's consent did not violate the covenant of good faith and fair dealing.[4]

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Bonaday therefore stands for the propositions that (a) the covenant of good faith and fair dealing will apply to a mortgagee's exercise of consent, even if such consent is entrusted to the lender's "sole and absolute discretion," and (b) nonetheless, such a covenant does not prevent a lender from conditioning its approval of a transfer of a mortgaged property upon amendments that would bring a mortgage to then current "market" standards.

Stith v. Hudson City Savings Institution, 63 Misc.2d 863, 313 N.Y.S.2d 804 (Sup. Ct. Broome Co. 1970), appears consistent with these propositions. In *Stith*, plaintiffs (who sought to sell their home) sought a declaration that the mortgagee had no right to condition approval of the purchasers' assumption of a mortgage upon payment of a higher rate of interest. The bond and mortgage at issue contained a due on sale clause that was triggered when the property was conveyed without the written consent of the mortgagee.

Finding the provision clear and unambiguous, the *Stith* court noted that the mortgagee need not accept the purchasers as "debtors and owners of the security," and held that the mortgagee was within its rights to seek additional compensation in return for assuming the risk associated with the purchaser.[5] Quoting a California state court case, the court made clear that a mortgagee could seek more favorable market terms when its consent is required and that its assent, conditioned by additional economic requirements, "demonstrated no lack of good faith or fair dealing, but merely insistence on its rights…"[6]

Importantly, both *Bonaday* and *Stith* appear to have involved residential properties. Indeed, in providing the basis for its decision, the court in *Bonaday* referred to a Federal Home Loan Bank Board policy, intended to promote liquidity in the residential mortgage markets, favoring "due on sale" clauses that enabled home loan lenders to "adjust [their] loan portfolio towards current market rates."[7]

The public policy rationale underlying the lending arrangements in *Bonaday* and *Stith* perhaps drove the result. Thus, the rationale behind these decisions might not apply in the commercial mortgage context, especially the CMBS context, where the loan agreements are designed to facilitate a transfer with the indebtedness in place.

It is also doubtful that these decisions would permit a lender to condition its consent on terms that were

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excessive or unreasonable, or go beyond what the current market would require. In such a situation, for example, a lender, might cite to *State Street Bank and Trust Co. v. Inversiones Errazuriz Limitada*, 374 F.3d 158 (2d Cir. 2004). In *State Street Bank*, defendants had defaulted under two credit agreements they had with State Street. State Street sued and obtained a default judgment. Defendants then moved to vacate the default judgment by asserting, among other things, that State Street had violated the covenant of good faith and fair dealing by withholding its consent to a sale of certain assets.

Defendants had obtained a potential buyer who had agreed to pay $140 million for these assets if State Street would consent to the sale. State Street conditioned its consent to the sale on being (a) paid $87 million from the proceeds of the sale and (b) provided with new collateral and economic benefits to which it would not have been entitled under the credit agreements. The potential buyer backed away from the transaction.[8] The defendants urged a finding that State Street's conditions were unreasonable and that State Street had arbitrarily refused to consent to the sale, thereby breaching the covenant of good faith and fair dealing.

The court noted that, although the covenant of good faith and fair dealing requires that parties, when given discretion, not act arbitrarily or irrationally, it is "not without limits, and no obligation can be implied that would be inconsistent with other terms of the contractual relationship."[9] Applying this standard, the court stated that "there are no express restrictions in the applicable negative covenants that limit State Street Bank's right to refuse to consent to any such sale in the event of a default. Accordingly the bank had the right under the Credit Agreements to 'withhold consent for any reason or no reason.'"[10] The court went on to note that State Street's conditions for consent were neither unreasonable nor arbitrary, since they were made "for a legitimate business purpose."[11] In light of *State Street Bank*, a lender might argue that a borrower would have to show that a lender's conditions serve "no legitimate business purpose."

On the other hand, *State Street Bank* involved a defaulting borrower. Courts may well be more willing to afford a lender a great deal of discretion to condition asset sales by a defaulting borrower. The decisions discussed above merely permitted a lender that was given the "sole and absolute discretion" to approve a new borrower the right to condition its approval on bringing the mortgage loan to current market standards—nothing more. Indeed, an argument could be made that allowing a lender to impose terms over and above what the current market would permit effectively prevents a borrower from transferring its property at all—which would completely undermine the borrower's bargained-for ability to transfer the property.

Interpreting contract provisions that require that consent not be "arbitrarily" or "unreasonably" withheld, New York courts have generally prohibited mortgagees from conditioning their consent upon the receipt of additional economic inducements.

In *Silver v. Rochester Savings Bank*, 73 A.D.2d 81, 424 N.Y.S.2d 945 (4th Dep't1980), the owner of a property had obtained a mortgage loan from a bank in order to construct a bank branch building on undeveloped land. The bank subsequently entered into a lease for the building. A proposed purchaser offered to buy the land, provided that the bank permitted the proposed purchaser to assume the mortgage without an increase in the interest rate. Although the bank conceded that the proposed purchaser was financially sound, the bank refused to consent to the transaction, and demanded that the interest rate be increased to accommodate prevailing market conditions. The mortgage also contained a due on sale acceleration clause that was triggered upon transfer of the property without the bank's consent. Importantly, the mortgage provided that the bank's consent to a proposed transfer "shall not be unreasonably withheld."[12]

The *Silver* court held that, "as a matter of law," the bank "cannot use the approval clause as a weapon to protect itself against the changed interest-market conditions."[13] The court recognized that in other cases involving due- on-sale clauses, banks had been permitted to impose interest rate increases. Nonetheless, it noted that the "reasonableness" requirement distinguished this case from the others:

The decision is notable for several reasons. First, it draws a distinction between due-on-sale acceleration provisions with "reasonableness" requirements and those without, finding the former to restrict mortgagees from imposing new conditions upon mortgagors when the mortgagee's consent to a transfer is sought. Second, the court found that the "reasonableness" requirement prevented the mortgagee from attempting to "alter the terms of the mortgage by raising the interest rate therein as a condition of approval," even though the court characterized rate increase as one to "current mortgage interest rates."[14] This suggests that, in the face of a "reasonableness" limitation on consent, a mortgagee would not be entitled to raise rates to then current market rates.

Negotiation of a reasonableness standard in mortgage loan documentation has clear value to a borrower under New York case law. However, even a sole discretion standard imposes limits on a lender's discretion due to the lender's implied duty of good faith and fair dealing, and a borrower will in all events be protected against arbitrary and irrational lender responses.

No doubt a mortgagee in a similar case could try to distinguish *Silver* on the ground that it views the buyer as "objectionable" on economic grounds. Yet, the holding in the case suggests such a determination itself would have to be a "reasonable" one.

In this regard, *Iris v. Marine Midland Bank of Southeastern New York, N.A.*, 114 Misc.2d 251, 450 N.Y.S.2d 997 (Sup. Ct. Sullivan Co. 1982), is also instructive. There, plaintiffs sought a declaration that the mortgagee could not threaten to accelerate the repayment of the mortgage unless the purchaser agreed to pay an increased interest rate. The relevant provision in the mortgage stated that, if the property was sold, the mortgagee had the option to accelerate repayment of the mortgage provided, however, that "such acceleration shall be based upon reasons that are not arbitrary or unreasonable." Id. at 251. The court held that an acceleration of the indebtedness would be unreasonable, and granted summary judgment for the plaintiff-mortgagor.

The *Iris* court made three noteworthy points. First, it stated that the "not arbitrary or unreasonable" clause was sufficiently different from other due on sale clauses to make cases such as *Stith*, supra, "inapplicable."[15] Second, the court noted that the distinction was particularly relevant in the context of commercial mortgages involving more sophisticated parties, since the reasonableness requirements effectively served to protect, for the mortgagor, any additional benefit that a favorable interest rate added to the resale value of the property.[16]

Third, as the foregoing paragraph makes clear, the court did not need to reach the question of whether the mortgagee's requests for an interest rate increase was reasonable—instead, it noted that the inclusion of "reasonableness" language meant that the parties intended to provide the mortgagor with the full benefit of a rate that was below prevailing market standards. As in *Silver*, the reasonableness limitation prevented the mortgagee from demanding an increase in the mortgage rate.

Negotiation of a reasonableness standard in mortgage loan documentation has clear value to a borrower under New York case law. However, even a sole discretion standard imposes limits on a lender's discretion due to the lender's implied duty of good faith and fair dealing, and a borrower will in all events be protected against arbitrary and irrational lender responses.

1. *Dalton v. Educ. Testing Serv.*, 87 N.Y.2d 384, 389 (1995); *Outback/Empire I L.P. v. Kamitis Inc.*, 825 N.Y.S.2d 747 (2d Dep't 2006) (duty of good faith applies even where provisions permitted party "sole and absolute discretion" to terminate obligations under lease).
2. Id., at 924.
3. Id., at 927.
4. Id.
5. Id., at 807.
6. Id., at 810.
7. *Bonaday*, 119 Misc.2d at 927. See also *First Federal Savings & Loan Assoc. of Rochester v. Jenkins*, 109 Misc.2d 715, 441 N.Y.S.2d 373 (Sup. Ct. Tompkins Co. 1981) (holding that due on sale clauses are generally enforced in New York).
8. Id., at 167-170.
9. Id. at 170 (citations omitted).
10. Id. at 170 (citations omitted).
11. Id.
12. Id., at 83.
13. Id., at 83-84.
14. Id., at 84, 86.
15. Id., at 253.
16. "In a commercial mortgage involving a substantial capitalization, the parties thereto are much more likely to actually negotiate the terms and conditions of the mortgage than would a home buyer for a one-family dwelling. The ability to resell the premises with the retention of a mortgage interest rate substantially below the current market quotations is indeed a potential economic benefit to the purchaser of real property. The clause in question affords potential purchasers an economic benefit, and as such, is in a very real sense, part of the consideration for the execution of the original mortgage. Mortgagors are assured that thereby, they can secure a buyer for resale subject to a substantially lower mortgage…. Nothing is contained therein which authorized the bank to withhold its consent absent an increased mortgage rate. Had that been intended, the defendants certainly could have included such a provision in the original mortgage." Id.