LENDING AND RESTRUCTURING ALERT
FEBRUARY 2002

No Good Deed Goes Unpunished: Creditor May Recover Against Party Not Liable on the Debt

What happens when a party writes a check to satisfy the debt of another to a creditor, but the check bounces? Under New York's negotiable instruments law, the creditor can recover from the maker of the bad check, even though the maker was not liable under the original debt.

The debtor owed money to a creditor and convinced his fiancé to write a check on his behalf, promising to deposit funds in her account to cover the check. Hopefully not indicative of the longevity of the marriage, the check was returned for insufficient funds. Rather than suing the debtor, the creditor sued the fiancé arguing that he was a holder in due course of the check and entitled to recover under Article 3 of the Uniform Commercial Code.

Finding that the creditor took the check in good faith, for value, and without notice of any defense, the court held that the creditor was a holder in due course and could collect from the fiancé even though she received no consideration for the check. The court found that the lack of consideration was not a viable defense to payment under the Uniform Commercial Code.

This decision, according to the court, achieves the objectives of the Uniform Commercial Code. First, it succeeded at "encouraging and facilitating the ready transaction of negotiable instruments, central to our credit economy." Second, it recognized that when an instrument which is dishonored is placed into the stream of commerce, the responsibility should fall on the party who is in the best position to prevent the loss. In this case, the fiancé was in the best position to prevent her check from being issued upon insufficient funds. Thus, the check-writer was required to make good on the check by paying the creditor.

Lender Overcomes Variety of Defenses of Corporate Borrower That We May Expect to See More Frequently

Now that we are in an economic downturn, we are seeing an appreciable rise in cases where borrowers try to evade liability after they have defaulted under their loan agreements. One recent case in New York Supreme Court certainly bodes well for lenders. The lender received a promissory note and loan agreement from a corporation and a personal guarantee, all signed by the same individual, one Mr. Sohn. In these documents, Mr. Sohn represented that he is a principal shareholder, director and officer of the corporation. The lender won summary judgment, after the court rejected the defendants' main arguments (which one of your borrowers may try to assert against you):

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- Documents Allegedly Executed Without Authority. The corporate borrower argued that it was not bound by the note because Mr. Sohn was not one of its officers or directors. The court ruled that, since Mr. Sohn represented in the loan documents that he was the president of the corporation, it was reasonable for the lender to rely on those representations. Thus, no trial was needed because Mr. Sohn had apparent authority to bind the corporation. As a practical matter, the court would not permit the corporation to evade liability after it admitted that it received the loan proceeds.

- Alleged Oral Agreement Not To Enforce the Note. The corporate borrower claimed that the lender orally promised that the loan would not have to be repaid unless the corporation first breached the right of first refusal granted to the lender under the loan agreement. The court held that this alleged oral agreement was barred under the Statute of Frauds because the written loan documents were found to constitute a complete, unambiguous agreement among the parties. Evidence of any alleged contemporaneous oral agreement contradicting the written agreement was therefore excluded.

- Usury. The annual interest rate under the note was 23%, which the defendants argued exceeded maximum rate (16% per annum) allowed under New York law on loans to individual borrowers. But a corporation may assert a defense of criminal usury in New York only when the interest rate exceeds 25% per annum. Furthermore, an individual may personally guarantee a note on behalf of a corporation even if the interest rate on that note exceeds 16%. Finally, in determining whether a loan is usurious, the lenders' attorneys fees are not included in the calculation of interest charged.

This case involved a loan of less than $2,500,000. Lenders should know that New York's usury laws do not apply to interest charged on loans of $2,500,000 or more. In addition, lenders can avoid problems of usury by including in their loan documents "savings clauses" which limit the actual interest rate to be charged to the maximum amount allowed under applicable law.

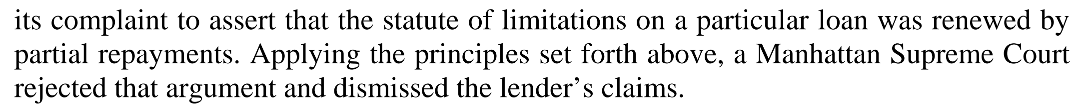
When Does Partial Payment on a Loan Re-start the Statute of Limitations

Under New York law, the six-year statute of limitations begins to run on a demand note when it is signed. But partial payment of an admitted debt can restart the statute of limitations where the lender proves that the payment was accompanied by circumstances amounting to an absolute and unqualified acknowledgment by the debtor of more being due, from which a promise to repay the remainder may be inferred.

If there is more than one debt, however, there must also be an indication that the debt sued on is the one that the borrower promised to repay. In addition, where the partial payment is made on condition that certain conditions are met, there is no unequivocal promise to repay and the statute of limitations is not renewed. One lender, who made ten different loans to a borrower, recently received an uncomfortable reminder of these rules.

The lender allowed the six-year statute of limitations to run on several loans. The lender then accepted payments from the borrower without clarification as to which loan(s) the payments would be applied.

The lender proceeded to sue on the several loans. In response to the borrower's claim that suit on the loans was time-barred, the lender argued that it should be permitted to revise



its complaint to assert that the statute of limitations on a particular loan was renewed by partial repayments. Applying the principles set forth above, a Manhattan Supreme Court rejected that argument and dismissed the lender's claims.

For more information on these issues, please call Paul Rubin **212-592-1448** or prubin@herrick.com, Andrew Gold **212-592-1459** or agold@herrick.com.

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