LENDING AND RESTRUCTURING ALERT
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Bank Not Liable on Commitment Letter

A recent case in California involving a lender's decision not to extend a loan after issuing a commitment letter to the prospective borrower underscores the importance of carefully documenting conditions to commitment letters. While the proposed borrower agreed to the terms of the commitment letter, because the letter did not set forth all of the material terms of the proposed loan, the court decided that no binding agreement was reached regarding the full scope of terms of the proposed loan.

The Facts

Following negotiations to refinance a commercial property, the bank's senior vice president wrote the borrower stating the proposed loan amount, loan pricing terms—including interest rate, loan fee and loan term—and that the letter was a conditional commitment of funds, contingent upon a satisfactory appraisal and the bank's receipt of requested documentation. The letter requested a response within 10 days.

The borrower replied within two days, agreeing to the conditional commitment on the terms stated, and enclosing a check for the appraisal fee. When the bank reviewed additional information provided by the borrower, however, the bank declined to extend the loan, stating that it determined that the building would generate insufficient cash flow. The borrower then sued the bank, alleging breach of contract due to alleged violation of the commitment letter, and negligent misrepresentation as to whether there had ever been a commitment to lend. The lower court granted the bank's motion to dismiss the action, and the appellate court affirmed.

The Reasoning for the Appellate Court's Decision

First, the court noted that a commitment letter, for which a fee is paid, constitutes an option to the applicant to obtain a loan on specified terms. But the court also observed that a loan commitment is not binding on a lender unless (a) the commitment letter contains all of the material terms of the loan and (b) either the lender's obligation is unconditional or its stated conditions have been satisfied. In this case, applying an objective analysis of the parties' communications, the court found that final agreement had not been reached regarding many terms, including the identity of the borrower, the necessary collateral, a repayment schedule or definition of rights and obligations upon default. Accordingly, the court determined that no contract had been formed.

Next, the court rejected the borrower's contention that its reasonable reliance on the bank's commitment letter by not seeking alternate financing should preclude the bank from disavowing the alleged promise to lend. The court reasoned that there was no clear promise to lend on terms certain, and there could not be justifiable reliance among these sophisticated parties under the circumstances.

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Finally, the appeals court affirmed that the negligent misrepresentation claim was "part and parcel" of the same contract claim, and was without merit in view of the written correspondence between the parties and the borrower's allegations.

Analysis and Implications

The court's ruling was not based on the absence of any particular loan term from the commitment letter. Rather it examined the communications between the parties within the context of the borrower's allegations and determined that the parties had not reached agreement on all material terms. As a result, lenders should craft with care both commitment letters and other correspondence with prospective borrowers. Though this case was decided under California law and therefore serves as direct precedent only in that state, it highlights for all lenders the importance of carefully documenting conditions to commitment letters, clarifying where additional negotiation as to essential terms remains necessary, and where the bank does not expect to decide whether to make a binding commitment until review of additional information pertinent to making the lending decision.

Should Worldcom, Inc. Have Filed for Bankruptcy in Mississippi?

Bankruptcy reform legislation proposed this month would require a debtor to file its bankruptcy case where it principally conducts its business. The plethora of recent corporate scandals prompted the introduction of this new legislation, which would also, among other things: (a) eliminate the protection from bankruptcy currently afforded asset securitizations; (b) give priority to pensioners' claims for violation of ERISA over those of secured lenders; (c) extend the reachback period for fraudulent conveyances, and (d) limit the availability of retention bonuses in bankruptcy cases.

The long-delayed bankruptcy bill previously proposed, which calls for considerable changes in consumer bankruptcies that are generally perceived as creditor-friendly, was nearly enacted in late July, but it will not be revisited by Congress until at least September. Notably, that legislation also calls for changes that would affect business bankruptcies, including placing limits on a debtor's exclusive right to file a plan of reorganization and its ability to extend its time to assume or reject commercial leases.

We will continue to keep you apprised of the progress of bankruptcy reform legislation and the important changes that could affect the lending community.

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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