LERCH EARLY & BREWER

Commercial Lending Bulletin

January 2009

OUR PROFESSIONALS

Lawrence G. Lerman
Chair
Email
301-657-0163

Joel S. Aronson
Email
301-347-1276

Cindi E. Cohen
Email
301-657-0169

Welcome to another issue of the *Commercial Lending Bulletin*, a newsletter published monthly by the Commercial Lending Group at Lerch, Early & Brewer as a service to our clients. Here, you will find articles written by our attorneys covering a variety of current legal issues as they affect lending law. We publish the *Bulletin* as part of our ongoing efforts to provide our clients with responsive service and practical advice when needed.

This newsletter is sent via email in HTML format. If you wish to print a copy of the newsletter, you may access a .pdf version by following the "Printer-Friendly version" link below.

We appreciate any feedback and invite you to contact us with any questions. If you do not want to receive any further newsletters from us, follow the link at the bottom of this email to be removed from our list of recipients.

Printer-Friendly Version (PDF Format)

In This Issue:

Changing Interest Rate Smacks of Fraud
A U.S. District Court in Kentucky found that a borrower who entered into an interest rate lock agreement could enjoin a lender who tried to change the interest rate and collect on a letter of credit posted for a rate lock fee.

No Lender Liability For Non-Binding Commitment Letter
The 11th U.S. Circuit Court of Appeals denied a prospective purchaser of a hospital the right to recover from a lender which ultimately did not provide the loan, on the grounds that the loan commitment letter was simply not intended by the parties to be a binding agreement.

Lack of Specific Contract Language Defeats Claim for Waste and Misrepresentation
A state appellate court exonerated a guarantor from liability by ruling that the debtor's change of hotel franchise to a Clarion Hotel after the expiration of the hotel's Holiday Inn license did not constitute "waste" in violation of the loan documents.

Tip Of The Month
The new year is a good time to review the existing loan portfolios to make sure that the required documentation from the loan closing has been received.

Changing Interest Rate Smacks of Fraud

A U.S. DISTRICT COURT IN KENTUCKY FOUND THAT A BORROWER WHO ENTERED INTO AN INTEREST RATE LOCK AGREEMENT COULD ENJOIN A LENDER WHO TRIED TO CHANGE THE INTEREST RATE AND COLLECT ON A LETTER OF CREDIT POSTED FOR A RATE LOCK FEE.

In June 2007 Robert Langley applied for a $43.3 million loan from Prudential Mortgage Capital Company LLC to finance a real estate development. The loan application included a "No Material Adverse Change" provision which stated "except as expressly provided herein PMCC shall be under no obligation to make the Loan and PMCC's determination to close and fund the Loan shall be subject to PMCC's sole determination that there have been no material adverse change to (or disruption in) financial banking, loan syndication, securitization, or capital markets." Another provision in the

Arthur F. Lafionatis
Email
301-657-0731

Alison W. Rind
Email
301-657-0750

Arnold D. Spevack
Email
301-657-0749

Vicki R. Canales
Email
301-907-2803

Jeremy I. Goldman
Email
301-657-0732

application permitted Langley to lock in the loan's interest rate if he entered into a rate lock agreement. Langley entered into certain rate lock agreements with Prudential, where the interest rate was locked at 6.3% and Langley provided Prudential a rate lock deposit in the form of a letter of credit in the amount of $860,000. The rate lock agreement provided that the rate lock deposit could be increased during the time of the rate lock agreement and required Langley at all times to have on deposit at Prudential an amount equal to twice the potential unwind costs.

After the rate lock agreements were finalized, Prudential advised Langley (1) it would not honor the locked rates and (2) required an increase in the rate lock deposit. Prudential made further demands for increases in the rate lock deposit until Langley eventually refused to pay. Prudential claimed that Langley's failure to increase the rate lock deposit was an unwind event and demanded payment of $4.1 million. Prudential further sought payment under the letters of credit for approximately $2 million. Langley sought an injunction against Prudential for payment under the letter of credit.

When reviewing whether to issue a preliminary injunction the Court must determine: (1) the likelihood that the party seeking the injunction will succeed on the merits of the claim, (2) whether the party seeking the injunction will suffer irreparable harm without the grant of the injunction, (3) the probability that granting the injunction will cause substantial harm to others and (4) whether the public interest is advanced by the issuance of the injunction.

In this case, the Court reviewed the Kentucky version of the UCC and determined that in limited circumstances the honoring of the letter of credit may be enjoined if there is fraud in the transaction. Langley argued that he had entered into the loan transaction based on his ability to lock the interest rate and Prudential's subsequent refusal to honor the locked interest rate constituted fraud. Prudential countered that the capital markets had changed and therefore pursuant to the "No Material Adverse Change" provision it could change the interest rate. The Court found that Prudential failed to address the conflict between the early rate lock provision and its "Adverse Change" provision in the application. Because Prudential entered into the rate lock agreements, Langley would reasonably believe he was locking the rate. The Court found that the rate lock agreements would seem to remove the concern Langley had regarding the "Adverse Change" provision. The Court stated that for Prudential to enter into the rate lock agreements, accept the rate lock deposits and then claim the rates were not locked "smacks of fraud". Finding that Langley was likely to win on the merits and the other elements were met, the Court issued the injunction in favor of Langley.

Lenders should review their applications and commitment letters to determine whether provisions such as rate lock provisions might possibly conflict with a "no material adverse change" contingency. In these volatile markets, a lender may want to retain the ability to change the interest rate as needed. In these instances, the lender must weigh the ability to change the interest rate versus the benefit of obtaining a rate lock deposit from a potential borrower. Courts are likely to find in favor of borrower if the lender is seen as trying to have its cake and eat it too. A lender must determine which provision in these instances is more important and delete the other conflicting provision.

This case is cited as *Langley, et. al. v. Prudential Mortgage Capital Co., L.L.C., et. al.*, No. 07-cv-404-JMH (E.D. Ky. 12/12/07)

No Lender Liability For Non-Binding Commitment Letter

THE 11TH U.S. CIRCUIT COURT OF APPEALS DENIED A PROSPECTIVE PURCHASER OF A HOSPITAL THE RIGHT TO RECOVER FROM A LENDER WHICH ULTIMATELY DID NOT PROVIDE THE LOAN, ON THE GROUNDS THAT THE LOAN COMMITMENT LETTER WAS SIMPLY NOT INTENDED BY THE PARTIES TO BE A BINDING AGREEMENT.

In 2000, Morningstar Healthcare, LLC desired to purchase a hospital from Princeton Hospital, Inc. which was embroiled in bankruptcy proceedings. In order to demonstrate to the bankruptcy judge that Morningstar was a legitimate purchaser, Morningstar requested a loan commitment letter from Greystone & Co., Inc. evidencing Greystone's agreement to fund Morningstar's purchase. Greystone provided a brief letter which described in general terms the amount of the loan, the interest rate and a repayment schedule. Subsequently, however, the parties were unable to agree on certain terms of the loan and the loan was ultimately never made. Morningstar sued Greystone in the U.S. District Court for the Middle District of Florida for failure to fund the loan.

Greystone filed a motion for summary judgment on the grounds that the loan commitment letter was not a binding, valid agreement demonstrating the mutual assent of the parties and that Greystone was additionally not obligated to fund the loan because certain conditions precedent were never fulfilled by Morningstar. The District Court agreed.

Shannon N. Mandel
Email
301-907-2815

Michael D. Smith
Email
301-657-0166

OUR SERVICES

Providing lenders with only the highest and most knowledgeable levels of lending counsel in all phases of commercial lending transactions.

Representing both borrowers and lenders in complex real estate and development transactions.

Advising and counseling in the structuring, documenting and closing of asset-based loans, and in the perfection of the lender's security interest.

Providing counsel to bank and non-bank lenders in closing government guaranteed loans under the 7(a), 504, B&I and "piggyback" loan programs.

Providing our clients with the

On appeal, the Circuit Court concurred, explaining that Morningstar's breach of contract action was implicitly predicated on the loan commitment letter being a valid agreement. However, the Court concluded that the letter lacked the terms and contingencies typically found in such complex financial agreements and was merely a letter which set forth some of the terms of a possible loan and, based on undisputed evidence, was not intended by the parties to be a binding contract.

The above case illustrates how important is for lenders to include within any non-binding loan commitment or letter of intent language which expressly provides that such commitment shall be non-binding.

This case is cited as: *Morningstar Healthcare LLC v. Greystone & Co. Inc.*, No. 07-14829 (11th Cir. 09/25/08).

Lack of Specific Contract Language Defeats Claim for Waste and Misrepresentation

A STATE APPELLATE COURT EXONERATED A GUARANTOR FROM LIABILITY BY RULING THAT THE DEBTOR'S CHANGE OF HOTEL FRANCHISE TO A CLARION HOTEL AFTER THE EXPIRATION OF THE HOTEL'S HOLIDAY INN LICENSE DID NOT CONSTITUTE "WASTE" IN VIOLATION OF THE LOAN DOCUMENTS.

Orix Capital Markets LLC and others were the owners and holders of a $6 million promissory note from K.C. Airport Hotel, Inc. which was guaranteed by American Realty Trust Inc. The Kansas City International Airport Holiday Inn was the security for the loan. When the franchise license came up for renewal in September 2002, Holiday Inn notified K.C. that the costs of required improvements before a new franchise license could be granted would be approximately $1.8 million. Ultimately, K.C. decided to enter into a franchise agreement with Clarion and thereafter the occupancy and revenues of the hotel declined. K.C. could not service the debt and eventually defaulted on the note, and the property was foreclosed.

Orix sued American Realty on the guaranty, contending that certain carve-out provisions for "waste" and/ or "fraud or material misrepresentation" in the non-recourse loan had been triggered. Orix contended that K.C. decided not to reapply for a license with Holiday Inn because of the cost of the required improvements. Orix further alleged that K.C. had concluded that it would be able to spend significantly less money by changing the franchise to a Clarion Hotel, despite the undisputed evidence that a Holiday Inn was the better "flag." In response, K.C. claimed that Holiday Inn had written a letter to K.C. in which Holiday Inn stated that it would not relicense the hotel as a Holiday Inn to K.C. After the trial judge entered a judgment for nominal damages in its favor, Orix appealed.

In the Texas Court of Appeals, Orix asserted that the loan documents clearly required K.C. to keep the hotel operating as a Holiday Inn, or as a comparable or better franchise, and failed to fulfill its obligations. In particular, claimed Orix, by failing to continue the Holiday Inn franchise, K.C. committed waste on the property since the hotel's value diminished significantly upon becoming a Clarion Hotel.

Despite these claims, the appellate court found nothing in the loan documents which specifically required K.C. to reapply for a franchise license with Holiday Inn. According to the court, the applicable covenant simply stated an agreement to continue to conduct and operate "the business", which the court interpreted simply to mean that K.C. was required to use the property as a hotel, but not necessarily as a Holiday Inn. The court ruled that, for waste to have occurred, it must have been committed "on the property." The court refused to interpret the loan documents to mean that waste should apply to "potential, future property, in this case a potential franchise license, that was never entered into." The court suggested that had K.C. prematurely terminated its franchise license with Holiday Inn and changed to a Clarion Hotel, waste might have been deemed to have occurred with respect to existing property. However, it ruled that changing to a Clarion after the Holiday Inn franchise license expired did not amount to any waste on the property. The court stated that if Orix wanted the hotel to remain a Holiday Inn, the contract should have specifically contained such a requirement.

Orix also argued that, based upon the carve-out provision for "fraud or material misrepresentation" contained in the guaranty, the trial court erred when it awarded only nominal damages to Orix, because Orix had proved as a matter of law that it suffered millions of dollars in damages. Orix claimed that K.C., not Holiday Inn, decided against the franchise renewal, but that K.C. misrepresented to Orix that the decision not to renew was Holiday Inn's.

In response, the appellate court reiterated that (i) Orix had no property interest in any future franchise licensing agreement and (ii) Orix did not specifically contract for the hotel to remain a

necessary resources to deal constructively with problem loans and the implementation of creative loan work-out arrangements.

PRACTICE AREAS

Business and Taxation

Commercial Lending

Community Associations

Creditors' Rights & Workouts

Elder Law

Employment and Labor

Estate Planning and Probate

Family Law

Health Care

Land Use and Zoning

Litigation

Real Estate Transactions

Holiday Inn. Therefore, the court ruled that even if misrepresentations were made, K.C. could not have caused any damages for something that it was not required to do; namely, to relicense as a Holiday Inn. Furthermore, said the court, no testimony had been given to show that even if K.C. had spent the $1.8 million, Holiday Inn would have renewed the license.

This case serves as a reminder to include all material covenants in the loan documentation. If a lender believes that a certain franchise is paramount to success of a borrower, it should include the requirement in the loan documents.

This case is cited as: *U.S. Bank etc., et al., v. American Realty Trust Inc.* No. 05-07-00328 (Tex. Ct. App. 06/12/08).)

Tip Of The Month

THE NEW YEAR IS A GOOD TIME TO REVIEW THE EXISTING LOAN PORTFOLIOS TO MAKE SURE THAT THE REQUIRED DOCUMENTATION FROM THE LOAN CLOSING HAS BEEN RECEIVED.

It should not take more than 2-3 months to obtain recorded documents and a final lender's title policy from a loan closing. When reviewing the recorded documents and the final title policy, make sure the legal descriptions contained in the loan documents match your final title insurance policy. Were there any post closing matters to be collected (ie, certificate of occupancy, life insurance, collateral assignments, etc)? It is much easier to collect documentation while a loan is in good standing. If any discrepancies arise, address them now, before the loan becomes classified.

We Would Like To Hear From You

We publish this newsletter as a service to our clients as a means to make them aware of certain aspects of the law. As always, we would like to hear feedback from our readers regarding the content of the newsletter. If there are items or topics you would like to see covered in future issues, or you have a suggestion concerning the newsletter itself, you may send them to Bill Melchior at **wgmelchior@lerchearly.com.**

Additionally, a number of the Firm's other departments periodically issue highly informative newsletters on a variety of other subjects, including Real Estate, Community Associations, and Employment and Labor. If you would like to view one or more of these newsletters, you may access them through our website, **www.lerchearly.com**.

SUITE 460 | 3 BETHESDA METRO CENTER | BETHESDA MD 20814-5367
TEL: 301.986.1300 | **www.lerchearly.com**
COPYRIGHT 2009, LERCH EARLY & BREWER, CHARTERED
The information in this newsletter is not intended to constitute legal advice and should not be acted upon without consulting an attorney.