Commercial Property - USA

Enforceability of distressed mortgage loan pre-negotiation agreements

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Following a mortgage loan default, many lenders will not engage in workout discussions with a borrower unless the borrower first executes a pre-negotiation agreement. Lenders may require pre-negotiation agreements from their borrowers following a mortgage loan default in order to:

- avoid inadvertent mortgage loan modifications by clarifying that negotiations between the borrower and the lender are discussions only and are not intended to be modifications of the mortgage loan until a written modification agreement is executed by the parties; and
- establish ground rules for negotiations.

In re Vargas Realty Enterprises, Inc v CFA W 111 Street, LLC(1) illustrates the use of pre-negotiation agreements. In its decision the US District Court for the Southern District of New York upheld the enforceability of pre-negotiation agreements.

The son and wife of the sole shareholder of an entity owning real property arranged for a mortgage loan to be made to the entity without the shareholder's knowledge or consent. The son and wife represented to the lender that they had the authority to enter into the financing transaction in the borrower's name. After the mortgage loan went into default, the lender filed a foreclosure action. In an effort to avoid foreclosure and reach a settlement or modification of the mortgage loan, the shareholder, on behalf of the borrower, signed a pre-negotiation agreement required by the lender, which:

- confirmed that the borrower's obligations were legal and enforceable;
- waived the borrower's defences, counterclaims and offsets; and
- acknowledged that the lender waived none of its rights or remedies under the mortgage loan documents.

After the parties failed to reach agreement on a modification of the mortgage loan terms, the borrower filed for bankruptcy and argued that the mortgage loan transaction was unenforceable because the son and wife lacked authority to enter into the transaction in the name of the borrower.

The borrower also argued that the pre-negotiation agreement was unenforceable for several reasons. First, the borrower argued that the pre-negotiation agreement lacked consideration. However, the court held that because the lender had no obligation to negotiate a workout, the lender's agreement to enter into negotiations was adequate consideration. Second, the borrower argued that the pre-negotiation agreement was a contract of adhesion and constituted a criminal enterprise. However, the court rejected this argument on the basis that the lender and the borrower were sophisticated parties represented by counsel and that there was no evidence of coercion or duress. Third, the borrower argued that the pre-negotiation agreement was a fraudulent conveyance under the US Bankruptcy Code. However, the court held that the pre-negotiation agreement was not a transfer of a property right, but instead only a ratification of the prior mortgage loan transaction. Finally, the borrower argued that the pre-negotiation agreement was against the public policy encouraging settlement discussions and was inadmissible in court because it was evidence of settlement discussions. However, the court held that the pre-negotiation agreement was evidence of the borrower's intent to ratify the underlying mortgage rather than evidence of the contents of an offer to settle. Furthermore, the court held that New York courts have consistently upheld the enforceability of pre-negotiation agreements on the basis of public policy favouring the enforcement of unambiguous contracts.

Therefore, the court held that the pre-negotiation agreement was enforceable. The court also held that the mortgage loan transaction was enforceable because, among other reasons, the pre-negotiation agreement evidenced a ratification of the underlying

mortgage loan by the shareholder of the borrower despite the fact that the mortgage loan was originally entered into by parties which lacked authority to enter into the mortgage loan transaction.

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Endnotes

(1) 440 BR 224 (SDNY 2010).