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FINANCE PROVIDERS NEED TO BE AWARE OF NEW COMMERCIAL FINANCE DISCLOSURE LAWS

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In June 2023, Florida and Connecticut became the sixth and seventh states, joining California, Georgia, New York, Utah, and Virginia, to enact a law requiring finance providers to disclose specified information in connection with commercial financing transactions.[1] Other states are considering similar legislation.

These disclosure requirements are complex, in part because they can apply to a variety of financing transactions, including loans, true factoring (*i.e.*, sales of existing receivables), merchant cash advances (*i.e.*, sales of future receivables) and leases, and concepts such as annual percentage rate do not make much sense for all of them. The statutes also vary significantly in almost every respect: as to which finance providers are covered (and which are exempt); what types of financing transactions are covered; what size transactions are covered; and what the consequences are for failure to comply. The charts at the end of this article depict some of the differences.

Finance providers – or counsel representing them – need to be aware of these laws and of the regulations interpreting and supplementing them. That is because there is a great deal of complexity in the disclosure requirements, particularly in California and New York. Perhaps more problematic, there is also significant uncertainty when each state's law applies, due to a lack of clarity about what finance providers are covered, what transactions are covered, or both.

Contents

WHAT FINANCE PROVIDERS ARE COVERED

Each state's law applies only to finance providers that engage in more than five covered transactions in a 12-month period. But it is not clear how that 12-month period is to be determined.[2] None of the statutes refer to "the previous 12 months." As a result, once a finance provider engages in a sixth transaction in a 12-month period, arguably the disclosure requirement kicks in for the preceding five transactions. While it seems doubtful that the statutes are designed to operate retroactively – after all, the purpose of the disclosures is to inform the recipient of the cost of the transaction before committing to it – a finance provider that contemplates engaging in more than five covered transactions in any 12-month period should err on the side of caution and assume that the statute applies.

WHAT TRANSACTIONS ARE COVERED

One might be tempted to think that these statutes are designed to protect businesses in the state that receive the type of financing to which the statute applies. In other words, that the location of the finance recipient is what matters.

Indeed, that appears to be the approach in Virginia. The Virginia statute defines "recipient" so as to limit the term to "a person whose principal place of business is in the Commonwealth."[3] It then defines the various terms for a covered finance provider as someone dealing with a recipient. As a result, the Virginia law applies only to transactions involving financing extended to a business with its principal place of business in Virginia.

The New York and California statutes are far less clear on this issue[4] but regulations in each state specify that the obligation to provide commercial finance disclosures applies only to recipients whose business "is principally directed or managed" within the state.[5] The regulations then expressly allow providers to rely on a written representation by the recipient as to whether the recipient is principally directed or managed from within the state or on the business address provided by the recipient in the application for financing.[6]

The Florida statute, while not a model of clarity, implies that it is based on whether the finance recipient is located in the state. It imposes disclosure obligations on a "provider," which is defined as "a person who consummates more than five commercial financing transactions with a business located in this state during any calendar year."[7] Although there is no specific requirement that, for the statute to apply to a transaction, the finance recipient must be located in the state, that does seem to be the intent.

On the other hand, the Georgia statute imposes disclosure obligations on a "provider," which is defined as "a person who consummates more than five commercial financing transactions in this state during any calendar year."[8] There is no specific requirement that either the finance recipient or a covered financing transaction be located in the state. There is also no guidance on how to determine whether a transaction is consummated in the state.

The Utah statute is similar. It requires"a person [engaging] in a commercial financing transaction as a provider in Utah or with a Utah resident," to register.[9] The term "provider" is defined as a person who consummates more than five commercial finance transactions "in the state" in any calendar year.[10] However, the disclosure obligation is not limited to providers who are registered or required to be registered; it applies to any provider "[b]efore consummating a commercial financing transaction."[11] There is also no express requirement that the funding recipient or the transaction be located in the state.

The Connecticut statute is perhaps the worst in this respect. It requires a "provider" that is *not* organized under the laws of the state to register with the state Banking Commissioner,[12] and requires providers – whether registered or not – to provide specified disclosures when extending a specific offer for sales-based financing.[13] The statute defines the term "provider" to *exclude* someone who extends not more than five commercial financing transactions "in this state" in a twelve-month period.[14] However, there is no requirement that a provider, a recipient, or a transaction be located in the state. As a result, there appears to be little or nothing required to connect the state to a transaction to which the statute purports to apply.

The uncertainty about when a state's law applies will likely only increase – as will the possibility that more than one state's law applies to a single transaction[15] – as these disclosure statutes proliferate, particularly if states choose different bases for applying their law. For now, finance providers that are not clearly exempt (*e.g.*, banks) should be cautious and seek legal advice any time the finance recipient is located in, the finance provider is located in, the transaction is entered into in, or payments are to be made in a state with a disclosure statute. One thing that is almost certain is that finance providers cannot avoid disclosure requirements by having the finance documents select as governing law the law of a state that has no such statute. A court in a state with a disclosure requirement is likely to regard the statute mandating disclosure as an expression of fundamental policy that contracting parties cannot generally avoid.[16]

POTENTIAL SURPRISES – COVERAGE OF BANK PARTNERS & INCOMPATIBLE RULES

Although all of the disclosure statutes exempt banks from having to make disclosures, the statutes do cover some entities that partner with a bank.[17] For example, if a bank's financing product is advertised online by and branded as a fintech company's product, the fintech company will likely be required to provide the relevant disclosures.

This can become problematic for any covered entity that wishes to offer its products online or otherwise across state lines. That is because the disclosure requirements not only vary, they are inconsistent on some points. For example, California apparently limits the disclosures provided to "only" the information specified in the regulation.[18] Because a description of collateral is not required, including such a description would seemingly not be allowed. Virginia, on the other hand, requires that a description of collateral be identified in its disclosures.[19] To deal with this, a covered entity might need to create state-specific disclosures and steer online users to the appropriate disclosure page. But for the reasons discussed above, it might be difficult to determine which state's (or states') law applies.[20]

POTENTIAL SURPRISES – INCREASES IN CREDIT & BRIDGE LOANS

The statutes are unclear as to whether and how they apply to refinancings and renewals. The New York statute is the only one to expressly address them, and it does impose disclosure requirements on some renewals. The California regulations effectively require disclosure any time there is an offer that would increase the interest rate, unless the increase were related to an agreement to resolve a default. That exception for post-default transactions would, however, likely not apply if the finance recipient was simply negotiating for a renewal or extension of the financing in advance of maturity.

Lenders and other providers of commercial finance that normally do not engage in transactions within the dollar limits of these disclosure statutes – for example, they lend more than $500,000 to California borrowers or more than $2.5 million to New York borrowers – might think that these statutes do not apply to them. Think again. Consider a situation in which the financed business requests a small increase in credit or a small bridge loan. Such a transaction might well fall within the dollar limits even though the entire credit exceeds the limits. If the lender engages in, or is likely to engage in, more than five such transactions in a 12-month period, the disclosure requirements would, apparently, apply.

A LOOK AHEAD

The Uniform Law Commission ("ULC") recently created a Study Committee to look into commercial finance disclosure and recommend whether the ULC should pursue uniform legislation on the subject. The Committee's first meeting was in March of this year and, since then, the Committee has been engaged in outreach to potential stakeholders and other interested parties. Given that commercial finance is largely a matter of interstate commerce and indifferent to state borders, it seems likely that there will be a strong desire for uniform legislation on the subject. Stay tuned.

	Size and Types of Transactions Covered				
	Dollar Amount	**Loans**	**True Leases**	**True Factoring**	**Merchant Cash Advances**
California	more than $5,000 and less than $500,000	√	√[21]	√	√[22]
Connecticut	not more than $250,000				√
Florida	less than $500,000	√		√	possibly[24]
Georgia	more than $50,000 and less than $500,000	√		√	possibly[24]
New York	less than $2,500,000	√		√	√[25]
Utah	less than $1,000,000[26]	√		√	possibly[27]
Virginia	less than $500,000				√[28]

	Exempt Finance Providers		
	Banks	**Frequency**	**Others**
California	Depository institution (defined)	Person making 5 or fewer covered transactions incident to its business in a 12-month period	Lender of at least $50,000 to a motor vehicle dealer or affiliate; lender regulated under the Farm Credit Act
Connecticut	Bank, bank holding company, or credit union (all undefined)	Person who extends not more than 5 covered transaction in this state in a 12-month period	Lender regulated under the Farm Credit Act
Florida	Federally insured depositary institution (or subsidiary or affiliate)	Person making 5 or fewer covered transactions in the state in a 12-month period	Lender of at least $50,000 to a motor vehicle dealer or affiliate; licensed money transmitter; lender regulated under the Farm Credit Act

	Exempt Finance Providers		
	Banks	**Frequency**	**Others**
Georgia	Federally insured depositary institution (or subsidiary or affiliate)	Person making 5 or fewer covered transactions in the state during any calendar year[29]	Lender of at least $50,000 to a motor vehicle dealer or affiliate; licensed money transmitter; lender regulated under the Farm Credit Act
New York	Financial institution (defined)	Person making 5 or fewer covered transactions in a 12-month period	Lender of at least $50,000 to a motor vehicle dealer or affiliate; technology services provider; lender regulated under the Farm Credit Act
Utah	Depositary institution (undefined)	Person consummating 5 or fewer covered transactions in any 12 month period[30]	
Virginia	Financial institution (undefined)	Person making 5 or fewer covered transactions in a 12-month period	

	Information to Be Disclosed						
	Finance Charge	**Interest Rate**	**Payment Amount**	**Fees**	**Total Amount to be Paid**	**Actual or Estimated Term**	**Collateral**
California	√	√[31]	√		√	√	
Connecticut	√		√	√	√	√	√
Florida				√[32]	√		
Georgia				√[33]	√		
New York[34]	√	√	√	√	√	√	√
Utah			√		√		
Virginia	√		√	√	√		√

	Remedy			
	Fine Payable to State	**Imprisonment**	**Injunction**	**Loss of Finance Charge**
California	Up to $10,000, if willful[35]	Up to 1 year, if willful		
Connecticut	Up to $100,000 per violation[36]		√[37]	
Florida	$500 per violation ($1,000 after notice of a prior violation)[38]		√[39]	Apparently not[40]
Georgia	$500 per violation ($1,000 after notice of a prior violation)[41]		√[42]	Apparently not[43]
New York	Up to $2,000 ($10,000, if willful)[44]		√[45]	Unclear[46]
Utah	$500 per violation ($1,000 after notice of a prior violation)[47]		√[48]	Apparently not[49]
Virginia			√[50]	Unclear[51]

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Notes:

1. *See* Cal. Fin. Code § 22780.1 & §§ 22800–22805 (enacted 2018); Conn. Pub. Law 23-201 (enacted 2023); Fla. Stat. §§ 559.9611 – 559.9615 (enacted 2023); Ga. Code §§ 10-1-393.18 – 10-1-393.19 (enacted 2023); N.Y. Fin. Serv. Law §§ 801–812 (enacted 2020 and amended 2021); Utah Code §§ 7-27-101 – 7-27-301 (enacted 2022); Va. Code §§ 6.2-2228–6.2-2238 (enacted 2022). The Florida and Georgia acts apply to transactions consummated on or after January 1, 2024. Fla. Stat. § 559.9612; Ga. Code § 10-1-393.18(e)(5). The Connecticut act applies to transactions made or offered on or after July 1, 2024. Conn. Pub. Law 23-201. The other statutes are already in effect and apply to any new transaction, although the disclosure requirements in California change slightly on January 1, 2024. *See* Cal. Fin. Code §§ 22802, 22803.

2. In addition, two of the statutes refer to both "any calendar year" and "any 12-month period," leaving it unclear which applies. *See infra* notes 25-26 and accompanying text.

3. Va. Code § 6.2-2228.

4. California requires a "provider subject to this division" to make disclosures. Cal. Fin. Code § 22802(a). There is no express statement about what providers are covered but any provider who makes five or fewer commercial financing transactions "in California" in a 12-month period is exempt

from the disclosure requirement. Cal. Fin. Code § 22801(e). This suggests that it is the location of the transaction that matters, but there is no provision specifying how the location of the transaction is to be determined.

The New York statute is similar. It imposes disclosure obligations on "a provider subject to this article." *See* N.Y. Fin. Serv. Law §§ 803, 804, 805, 806. There is no express statement identifying what providers are subject to the article, although § 802 exempts any "provider who makes no more than five commercial financing transactions in this state in a twelve-month period."

5. Cal. Code Regs. tit. 10, § 954(a); N.Y. Comp. Codes R. & Regs. tit. 23, § 600.24(a).

6. Cal. Code Regs. tit. 10, § 954(b); N.Y. Comp. Codes R. & Regs. tit. 23, § 600.24(b).

7. Fla. Stat. § 559.9611(1).

8. Ga. Code § 10-1-393.18(a)(10).

9. Utah Code § 7-27-201.

10. Utah Code § 7-27-101(9)(a). There is also an exemption for a provider that consummates five or fewer commercial financing products "in the state" during any 12 month period. Utah Code § 7-27-102(5). It is not clear whether or how the undefined term "commercial financing product" differs from a "commercial financing transaction," which is defined. Utah Code § 7-27-101(5). There is also no guidance on how to determine whether a transaction or product is consummated in the state.

11. Utah Code § 7-27-202(a)(1).

12. Conn. Pub. Law 23-201, § 10(a).

13. *Id.* § 3.

14. *Id.* § 1(6).

15. The Connecticut statute has a novel provision designed to avoid conflicts with other state disclosure laws. If the Banking Commissioner determines that the laws of another state require disclosures that meet or exceed the requirements of the Connecticut statute, then any disclosure form that the other state approves for the purposes of complying with its law may be used to satisfy the Connecticut disclosure statute. *Id.* § 7.

16. *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 187(2)(a).

17. *See* Cal. Fin. Code § 22800(m) (defining "provider" to include "a nondepository institution which enters into a written agreement with a depository institution to arrange for the extension of commercial financing by the depository institution to a recipient via an online lending platform administered by the nondepository institution"); Cal. Code Regs. tit. 10, § 900(a)(24) (excluding arrangements in which "the nondepository institution has no interest, or arrangement or agreement to purchase any interest in the commercial financing extended by the depository institution in connection with such program, and the commercial financing program is not branded with a trademark owned by the nondepository institution."); N.Y. Fin. Serv. L. §§ 801(h), 802(b) (similar to the California statute but lacking the reference to how the program is branded); Fla. Stat. § 559.9611(10) (defining "provider" to include "a person who enters into a written agreement with a depository institution to arrange a commercial financing transaction between the depository institution and a business via an online lending platform administered by the person"); Ga. Code § 10-1-393.18(a)(10) (similar to the Florida definition); Utah Code § 7-27-101(9)(b) (similar to the Florida definition).

The Virginia statute is less clear on this point. It defines a "provider" to include "a person that solicits and presents specific offers of sales-based financing under an exclusive contract or arrangement with a provider." Va. Code § 6.2-2228. Although the statute does not apply to and places no obligations on a financial institution, Va. Code § 6.2-2229(1), it does not exclude financial institutions from the definition of "provider." Consequently, a person that has an exclusive contract to solicit or present offers made by a financial institution would appear to be a provider covered by the statute unless some other exemption applies.

18. See Cal. Code Regs. tit 10, §§ 910 – 917, which require that the mandated disclosure be formatted in a table with a specified number of rows and columns, and stating that each row include "only" specific information. However, there is no specific prohibition on providing additional information outside the mandated table.

19. Va. Code § 6.2-2231(8).

20. In addition, California and New York require that the required disclosures be presented to the recipient as a separate document, Cal. Code Regs. tit. 10, § 901(a)(6); 23 N.Y. Comp. Codes R. & Regs. § 600.5(e), and that the financing recipient "sign" the disclosure prior to consummation of the financing, Cal. Code Regs. tit. 10, § 901(a)(2); 23 N.Y. Comp. Codes R. & Regs. § 600.5(b). Online providers will need to build this type of functionality into their user interface and ensure that a record is maintained of the disclosures made and the applicant's assent.

21. If the lessee has an option to purchase. *See* Cal. Fin. Code § 22800(j).

22. Covers an "asset-based lending transaction," defined to mean " a transaction in which advances are made from time to time contingent on a recipient forwarding payments received from one or more third parties for goods the recipient has supplied or services the recipient has rendered to that third party or parties." *See* Cal. Fin. Code § 22800(c).

23. The Florida statute defines an "accounts receivable purchase transaction," to which disclosure requirements applies, as "a transaction in which a business forwards or otherwise sells to a person all or a portion of the business's accounts or payment intangibles as those terms are defined in [the state's version of U.C.C. § 9-102(a)] at a discount to the expected value of the account or payment intangibles." Fla. Stat. § 559.9611(1). Article 9 defines both accounts and payment intangibles as a "right to payment," and thus implies that the right must presently exist. On the other hand, a security agreement can cover after-acquired collateral, although the security interest will not attach to such property until the debtor acquires rights in or the power to transfer rights in it. *See* U.C.C. §§ 9-203(b)(2), 9-204(a). It remains unclear whether the Florida disclosure statute is intended to or does cover sales of future receivables.

24. The Georgia statute defines an "accounts receivable purchase transaction" using almost identical language as the Florida statute, *see* Ga. Code § 10-1-393.18(a)(1), and therefore has the same lack of clarity on this issue.

25. The act covers "sales-based financing," which is defined to mean "a transaction that is repaid by the recipient to the provider, over time, as a percentage of sales or revenue, in which the payment amount may increase or decrease according to the volume of sales made or revenue received by the recipient." N.Y. Fin. Serv. Law § 801(j). This may include a so-called "reconciliation" process, in which the amount of periodic payments, which was originally set based on expected receipts, is adjusted to reflect actual receipts.

26. There is a smaller cap – $50,000 – if the financed business is a motor vehicle dealer. Utah Code § 7-27-102(9).

27. The Utah statute defines an "accounts receivable purchase transaction" using almost identical language as the Florida and Georgia statutes. *See* Utah Stat. § 7-27-101(a).

28. The act covers "sales-based financing," which is defined to mean "a transaction that is repaid by the recipient to the provider, over time, as a percentage of sales or revenue, in which the payment amount may increase or decrease according to the volume of sales made or revenue received by the recipient." This may include a reconciliation process. Va. Code §§ 6.2-2228, 6.2-2231.

29. The statute defines a covered provider as someone who consummates more than five commercial financing transactions in this state "during any calendar year" but then exempts a provider that consummates five or fewer commercial financing transactions in the state "during any 12 month period." Ga. Code § 10-1.393.18(a)(10), (b)(5). It is unclear why the statute uses these two, slightly different, time periods.

30. In addition to exempting a provider who consummates five of fewer commercial financing transactions in the state "during any twelve month period," Utah Code § 7-27-102(5), the statute defines a provider to be a person who consummates more than five such transactions in the state "during a calendar year." Utah Code § 7-27-10(9)(a). It is unclear why the statute uses these two, slightly different, time periods.

31. Disclosure of the "total cost of the financing expressed as an annualized rate" is not required for transactions entered into after January 1, 2024. *See* Cal. Fin. Code §§ 22802, 22803.

32. Expressed as the total dollar cost, calculated as the difference between the amount disbursed to the business and the amount to be paid by the business. Fla. Stat. § 559.9613(2).

33. Expressed as the total dollar cost, calculated as the difference between the amount disbursed to the business and the amount to be paid by the business. Ga. Code § 10-1-393.18(e)(3).

34. Varies with the type of transaction. *See* N.Y. Fin. Serv. Law §§ 803 (governing sales-based financing), 804 (governing closed-end commercial financing), 805 (governing open-end commercial financing), 806 (governing factoring transactions), 807 (governing other financing transactions), 808 (governing renewal transactions).

35. *See* Cal. Fin. Code §§ 22713, 22780, 22805.

36. *See* Conn. Pub. Law 23-201, § 12(b); Conn. Stat. § 36a-50(b).

37. *See* Conn. Pub. Law 23-201, § 12(a).

38. *See* Fla. Stat. § 559.9615(2) (also limiting the fines to $20,000 – $50,000 if willful – for all violations arising from the same transaction documents or materials).

39. *See* Fla. Stat. § 559.9615(1)(c) (authorizing the state attorney general to "commence administrative or judicial proceedings to enforce" the act).

40. Expressly neither affects the enforceability of the underlying agreement nor creates a private right of action. Fla. Stat. § 559.9615(2)(c), (3).

41. *See* Ga. Code § 10-1-393.18(h) (also limiting the fines to $20,000 – $50,000 if willful – for all violations arising from the same transaction documents or materials).

42. *See* Ga. Code § 10-1-393.18(g) (authorizing the state attorney general to "[c]ommence administrative or judicial proceedings . . . to enforce compliance" with the statute).

43. Expressly neither creates a private right of action nor affects the enforceability of the underlying agreement. Ga. Code. § 10-1-393.18(j), (k).

44. *See* N.Y. Fin. Serv. Law § 812(a).

45. *See* N.Y. Fin. Serv. Law § 812(b) (authorizing the superintendent to issue "a permanent or preliminary injunction on behalf of any recipient affected by the violation.").

46. The superintendent may, upon finding that a provider knowingly violated the act, order "restitution." N.Y. Fin. Serv. Law § 812(b). There is no explanation of what restitution covers.

47. *See* Utah Code § 7-27-301(2), (3) (also limiting the fines to $20,000 – $50,000 if willful – for all violations arising from the same transaction documents or materials).

48. *See* Utah Code § 7-27-301(1)(c) (authorizing the state Department of Financial Institutions to "commence administrative or judicial proceedings . . . to enforce compliance" with the statute).

49. Expressly neither creates a private right of action nor affects the enforceability of the underlying agreement. Utah Code § 7-27-301(4), (5).

50. Va. Code § 6.2-2238(A).

51. *See* Va. Code § 6.2-2236 (providing that "[i]f any provision of a sales-based financing agreement violates this chapter, such provision shall be unenforceable against the recipient."). *See also* Va. Code § 6.2-2238(B) (authorizing the state attorney general to seek "damages and such other relief allowed by law, including restitution to the extent available to borrowers under applicable law.").

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New York Court Refuses to Enforce Break-up Fee

Stephen L. Sepinuck

A 2014 article in this newsletter[1] discussed *White Winston Select Asset Funds, LLC v. InterCloud Systems, Inc.*,[2] in which a federal district court applying New York law ruled that a break-up fee called for in a term sheet for a loan was unenforceable. The court concluded that the term sheet was merely an agreement to agree and created no binding obligations. The article criticized the decision and suggested that prospective lenders and their counsel, instead of drafting term sheets and letters of intent, enter into binding agreements with prospective borrowers. The prospective lender in such an agreement would not promise to make the loan, merely promise to perform due diligence.

Fortunately, the district court's decision was reversed on appeal.[3] That ruling breathed new life into term sheets and letters of intent, but did nothing to undermine the prior article's suggestion of a different approach. Unfortunately, a decision by a Supreme Court in New York earlier this year calls into question the enforceability of any promise by a prospective borrower to pay costs and a break-up fee, whether structured as a term sheet, letter of intent, or binding agreement.[4] The decision is poorly reasoned and flawed in several respects. Nevertheless, unless and until reversed on appeal, prospective lenders and their counsel need to be aware of the decision and do their best to draft around it.

THE DECISION

In 2017, Cascade 553 LLC, a real estate development company, sought $110 million in financing from SPG Capital Partners. The parties signed a Term Sheet stating that SPG Capital was "devoting time and resources" to its due diligence investigation. The Term Sheet also required Cascade to pay a $200,000 deposit (which Cascade did), negotiate exclusively with SPG Capital for a specified period of time, and pay SPG Capital's expenses and a 2% break-up fee ($2.2 million) if Cascade obtained mortgage financing elsewhere or elected not to proceed with the loan.

Cascade later obtained financing from another party and SPG Capital sued for the break-up fee and its expenses. Cascade denied liability for breach of the Term Sheet and counterclaimed for return of its deposit. Both parties moved for summary judgment.

The court held that the Term Sheet, taken as a whole, was unenforceable, relying primarily on express language stating that the document was "a proposal," was "for discussion purposes only," and was not "an offer, agreement, or commitment to lend or borrow."[5]

The court then ruled that the exclusivity provision alone was not separately enforceable. Although the Term Sheet provided that the exclusivity provision, including Cascade's promise to pay the break-up fee, "shall survive the termination of this Term Sheet," there was "no statement that renders the [exclusivity] provision enforceable notwithstanding the non-binding nature of the [T]erm [S]heet."[6]

Moreover, and equally troubling, the court indicated that there was no "mutuality of consideration" to support the exclusivity provision. Although SPG Capital argued that its obligation to perform due diligence and negotiate in good faith provided the requisite mutuality of obligation, the court concluded that the Term Sheet expressly indicated that SPG Capital intended not to be bound, and hence there was no duty to perform due diligence or to negotiate in good faith.[7] The court also indicated that "courts have found mutuality only where the obligation is *much greater than that at hand*" (emphasis added). It noted that an exclusivity clause is independently enforceable only if there is "a clear expression of intent, along with mutuality of obligation," and then proceeded to distinguish an earlier case that held that forbearance to assert a colorable claim constitutes "sufficient consideration" to support a contract.

The court therefore issued summary judgment against SPG Capital on its claims for the break-up fee and for Cascade on its claim for return of the deposit, but less any expenses that SPG Capital had paid in conducting its due diligence.[8]

ANALYSIS OF DECISION

The court's decision is – to put it bluntly – wrong. Viewed objectively, there can be no reasonable doubt that the intent of the parties was to bind Cascade to negotiate exclusively with SPG Capital, to pay SPG Capital's due diligence expenses, and to pay the break-up fee if Cascade obtained financing elsewhere, while not obligating SPG Capital to make the loan. Yes, the Term Sheet could have, and should have, made that intent more clear. But that is the basic intent of most parties to a term sheet for a business loan. Moreover, the term stating that the exclusivity clause "shall survive the termination of this Term Sheet" strongly implies that the parties intended the clause to be binding. If the clause were not binding, there would be no need for it to survive termination of the Term Sheet.

More important, the portion of the court's opinion dealing with "mutuality" is simply a mess. First, it is unclear precisely to what doctrine the court was referring. There is the doctrine of consideration and the doctrine of mutuality, but these doctrines are distinct and different concepts.

The requirement of consideration means that a promise must be supported by some bargained-for exchange. Mutuality of obligation is the supposed idea that either both parties are bound or neither is bound. But mutuality of obligation is not a true requirement of contract law.[9] Indeed, just last year a court applying New York law explained that modern courts have rejected the concept of mutuality of obligation as "antiquated," finding that so long as a contract is supported by consideration, there is no additional requirement of mutuality of obligation.[10] In fact, this is not a recent development. Mutuality has long been a chimera or figment of contract law. In the classic case of *Hamer v. Sidway* – a New York case – the court enforced an uncle's promise to pay a nephew for refraining from tobacco, alcohol, and gambling.[11] The nephew never promised to refrain, nor did the uncle seek such a promise. What the uncle sought and the nephew admittedly provided was performance. As a result, the nephew had no obligation at all. "Mutuality of obligation" is a phrase that judges continue to use, but usually when they do not know what they are talking about.[12]

So, if the court in *SPG Capital Partners* really meant that the exclusivity clause could not be enforced due to a lack of mutuality of obligation, it was simply wrong, both because there was an implied promise to perform due diligence[13] and because mutuality of obligation is not needed.

Even if the court meant that the problem with the Term Sheet was a lack of consideration, the court was still wrong. In a bilateral contract, each party's promise is supported by a promise of the other. In a unilateral contract – as in *Hamer v. Sidway* – one party's promise is supported by the other party's performance. Thus, even if SPG Capital never promised to perform due diligence – even if it never promised to do anything – its act of expending resources to investigate the desirability of making the loan, *if bargained for*, would provide the requisite consideration for Cascade's promise to negotiate exclusively with SPG Capital and to reimburse expenses and pay the break-up fee. In such a case, consideration would not exist at the time the Term Sheet was signed, and hence Cascade could rescind its promise before SPG Capital began performance.[14] But once SPG Capital began performance, there could be no defense based on lack of consideration.

The court's analysis is troubling for three additional reasons. First, if the court truly meant what it said when it ruled that the exclusivity clause was unenforceable, then there was no basis for its ruling that SPG Capital could deduct its expenses before refunding Cascade's deposit. In other words, if, as the court stated, both the Term Sheet as a whole and the exclusivity clause separately were unenforceable, Cascade had no binding duty to pay SPG Capital's expenses. But the court imposed such an obligation anyway.[15]

Second, there is language in the opinion suggesting that the court was troubled by *the amount* of consideration/mutuality. Specifically, the court stated that other "courts have found mutuality only where the obligation is much greater than that at hand," and then distinguished a case that enforced a $2 million breakup fee that applied to whichever party failed to execute the lease in question.[16] But courts do not typically question the amount of consideration, merely whether it exists.[17] Moreover, there is a logical fallacy in the court's reasoning. Condensed down, the court reasoned that in the cited case, which enforced a breakup fee, there was greater consideration, so the break-up fee in this case is unenforceable. Aristotle would not be impressed.

Finally, the court's analysis and ruling place a large obstacle in the path to the enforceability of break-up fees, one that is difficult to steer around even with careful drafting. If, as the ruling suggests, neither a prospective lender's actions in performing due diligence nor its promise to undertake such actions can be sufficient consideration for a prospective borrower's promise to pay a break-up fee, then it is unclear how such a promise from a prospective borrower could ever be enforceable. Noticeably, nothing in the court's decision satisfactorily explains why its ruling is consistent with the numerous decisions enforcing, under New York law, a promise to pay a break-up fee.

ADVICE TO TRANSACTIONAL LAWYERS

Some aspects of the court's decision are relatively easy to address when drafting a term sheet. The Term Sheet in the case stated:

> This Term Sheet is for discussion purposes only and is subject to Lender's satisfactory completion of its due diligence, internal credit approvals and satisfactory legal review.
>
> * * *
>
> [This Term Sheet is not] an offer, agreement, or commitment to lend or borrow.

The first statement was problematic. It is one thing to disclaim any duty *to make the loan*. It is quite another to assert that the entire Term Sheet is not binding. The second statement suffers from the same problem because it is ambiguous: the phrase "to lend or borrow" might modify all three preceding nouns ("offer, agreement, or commitment") or might modify only the closest ("commitment"). As a result, it is unclear whether the second statement disclaims that the Term Sheet is an agreement to lend, or whether it disclaims that the Term Sheet is an agreement at all.

Thus, the first statement should either not have been included or should have been appropriately limited to the non-binding provisions. The second statement should have been phrased so as to avoid the ambiguity. Frankly, something much shorter and simpler, such as the following, would have sufficed:

> Nothing in this Term Sheet requires either party to lend or borrow.

Better yet, a term sheet should expressly indicate what portions are binding and what portions are not. Specifically, a term sheet should state that the provisions on exclusivity and for payment of expenses and the break-up fee are binding and survive termination of the term sheet. If a term sheet includes a choice-of-law clause – which by itself also implies that at least some portions of the term sheet are binding, and thus might be wise to include – then the term sheet should state that the choice-of-law clause also is binding and survives termination of the term sheet.[18] If a term sheet includes a promise of confidentiality – by either or both parties – then that clause too should likely be included in the list of terms that are binding and that survive termination of the term sheet.

To deal with the consideration problem created by *SPG Capital Partners*, a term sheet should identify the consideration for the prospective borrower's binding promises. For example the provision on payment of expenses and the break-up fee could begin as follows:

> In consideration of [Lender's] [promise to expend] time and resources investigating the desirability of making and negotiating the terms of the Loan, [Borrower] shall pay [ ].

Notice that the suggested language includes brackets around the phrase "promise to expend." The bracketed language should be included only if the prospective lender wishes to promise to engage in due diligence. Regardless of whether that promise is made, bear in mind that a recital of consideration may be contradicted by testimony even if the agreement is fully integrated.[19] Nevertheless, the language should signal to those later litigating the issue, as well as to the court, what the consideration is supposed to be, and might create a presumption that consideration exists. It also strengthens the argument that the prospective borrower's promise to pay expenses and the breakup fee is intended to be binding even though the prospective lender has not promised to make the loan.

Finally, another point of advice about term sheets made in the 2014 newsletter article remains sound: do not include a promise by the prospective borrower to refrain from seeking or obtaining a loan from another source. Instead, simply include a promise to pay the break-up fee if the prospective borrower obtains funding elsewhere. If a term sheet includes a promise of exclusivity, then the break-up fee becomes a type of liquidated damages clause[20] – that is, an amount due for breach – in which case the fee could be invalidated as a penalty if the amount is not a reasonable estimate of actual or anticipated damages. If, however, the prospective borrower makes no promise of exclusivity, then the borrower does not breach by getting funding elsewhere, the break-up fee is not a form of liquidated damages, and the fee cannot be invalidated as a penalty. In such a situation, the break-up fee is analogous to a payment for exercising an option, on which there is no legal limit other than unconscionability.[21]

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Notes:

1. *See* Stephen L. Sepinuck, *Term Sheets, Letters of Intent, and Preliminary Agreements: Ensuring Recovery of Expenses*, 4 The Transactional Lawyer 2 (Oct. 2014) (hereinafter *Term Sheets*).

2. 2014 WL 4105492 (D.N.J. 2014).

3. White Winston Select Asset Funds, LLC v. Intercloud Systems, Inc., 619 F. App'x 157 (3d Cir. 2015).

4. *See* SPG Capital Partners LLC v. Cascade 553 LLC, 180 N.Y.S.3d 524 (Sup. Ct. 2023).

5. 180 N.Y.S. 524, at *5.

6. *Id.* at *6.

7. *Id.*

8. *Id.* at *8.

9. *See* Restatement (Second) of Contracts § 79(c) & cmt. f.

10. Alessi Equip., Inc. v. America Piledriving Equip., Inc., 578 F. Supp. 3d 467, 499-500 (S.D.N.Y. 2022).

11. *See* 27 N.E. 256 (N.Y. 1891).

12. For example, in Dorman v. Cohen, 413 N.Y.S.2d 377 (Sup. Ct. 1979), the court wrote that a *bilateral agreement* requires mutuality of obligation, otherwise it is illusory. *Id.* at 79. Later courts have taken this out of context and stated in much broader terms that "[a]n agreement is illusory, and therefore unenforceable, if it lacks mutuality of obligation." *See*, *e.g.*, Lord v. The Limited Liability Co., 146 N.Y.S.3d 466, at *4 (Sup. Ct. 2021). *See also* Leisure Time Travel, Inc. v. Villa Roma Resort and Conference Ctr., Inc., 52 N.Y.S.3d 621, 623 (Sup. Ct. 2017) (ruling that the doctrine of impossibility had excused performance but then unnecessarily and erroneously indicating that meant there was no mutuality of obligation).

13. It is worth noting that prospective lenders do not issue term sheets for the purpose of having their expenses reimbursed or with the goal of receiving a break-up fee. They do so in pursuit of a loan transaction, from which they hope to realize a profit. The lender expects to pursue the financing, and is committing itself to work towards that objective; the lender is simply not committing itself to make the loan until it completes the due diligence investigation and even then only if it is satisfied with what it learns from that investigation.

14. *See* Restatement (Second) of Contracts §§ 45, 62.

15. The Term Sheet stated that "if lender or Borrower chooses not to proceed with the Loan, Lender's expenses, including due diligence costs and legal fees, will be reimbursed, any remaining funds from Good Faith Deposit will be returned to the Borrower." 180 N.Y.S.3d 524, at *8. Accordingly, the Term Sheet was clear that the expenses were to be deducted. But the court offered no explanation as to why this term was enforceable when the promise to pay the break-up fee was not.

16. *Id.* at *7.

17. *See* Restatement (Second) of Contracts § 79(b) & cmt. c; Alessi Equip., Inc., 578 F. Supp. 3d at 500.

18. The same advice applies to a choice-of-forum clause or arbitration clause, a provision on how notifications must be provided, and to a clause disclaiming the existence of any third-party beneficiary.

19. *See* Restatement (Second) of Contracts § 218 & cmt. e. *See also* Cal. Evid. Code § 622 (while most facts recited in a written agreement are conclusively presumed to be true as between the parties, a recital of consideration is not).

20. The Term Sheet in the *SPG Capital Partners* case expressly stated that the break-up fee was liquidated damages. 180 N.Y.S.3d 524, at *1.

21. *See Term Sheets*, 4 The Transactional Lawyer at 3.

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Recent Cases

SECURED TRANSACTIONS

Attachment Issues

Bank of America v. Third Avenue Imaging LLC, 2023 WL 3818549 (S.D.N.Y. 2023)

Although a secured party was entitled to summary judgment on its claims against the borrower and three guarantors for nonpayment of the debt and foreclosure of the security interest granted by each of them, the secured party was not entitled to summary judgment on its claims against a professional corporation that allegedly also guaranteed the debt and granted a security interest. The corporation had raised a material question of fact about whether the individual who signed the loan documents as its "authorized signatory" was in fact authorized to do so. The individual was not a physician and had never been a shareholder, officer, or director of the professional corporation. Moreover, the document purporting to be a resolution authorizing the individual to serve as an authorized signatory contained the signature of the corporation's president but the page on which the signature appeared began with a new sentence, whereas the previous page ended in mid-sentence, creating a question as to whether it was truly part of the same document.

In re Main Street Business Funding, LLC, 2023 WL 4420519 (D. Del. 2022)

The bankruptcy court properly concluded that, of the debtor's claims against a consultant for fraudulent misrepresentation, conversion, civil conspiracy, unjust enrichment, breach of fiduciary duty, aiding and abetting breach of fiduciary duty, and legal malpractice, only the unjust enrichment claim sounded in contract; all the others sounded in tort. Pursuant to the "gist of the action" doctrine, the entire claim was therefore a commercial tort claim. It did not matter that the insurer that funded the settlement cannot defend an insured for the insured's own intentional torts because the gist of the action doctrine is based on the nature and merits of the claims, not the identity of the payor. Accordingly, the secured party's security agreement, which described the collateral as "all tangible and intangible personal property of the Debtor, . . . including" specified types of collateral, did not adequately describe commercial tort claims under § 9-108(e)(1) and therefore did not encumber the claims. The security interest could not have attached to the claims as proceeds of other collateral because the claims arose before the security agreement was authenticated.

Enforcement Issues

Nissan Motor Acceptance Corp. v. Infiniti of Englewood, LLC, 2023 WL 4197143 (D.N.J. 2023)

Car dealers raised a factual dispute that prevented summary judgment on a floor plan financier's claim for selling cars out of trust by alleging that the financier knew of the sales and, by routinely accepting late payment, had waived the requirement for prompt payment. Although the security agreements provided that no waiver would be effective against the financier unless in writing and signed by an executive officer of the financier, a contract provision that requires a modification be in writing may be expressly or impliedly waived by the clear conduct or agreement of the parties.

Credit Acceptance Corp v. Holness, 2023 WL 4568737 (N.Y. Cty. Ct. 2023)

Although retail instalment sales contracts for motor vehicles are exempt from New York's usury statute, that exemption applies only to the seller and to a financing agency that buys the contract from the seller. The exemption does not apply to a financier that contracts directly with the buyer or that uses a retail instalment contract as a vehicle for avoiding usury laws. The contract in this case, while ostensibly between the buyer and the seller, was a pre-printed form labeled as the financier's form and bearing a copyright mark and reservation of rights by the financier at the bottom of each page. Pre-printed language immediately assigned the contract to the financier so that not a single payment was scheduled to be made to the seller. Additionally, the contract required all notices under the arbitration clause to be sent to a post office box where the financier, not the seller, was located, and the last page identified the financier as a party to the contract. Accordingly, the transaction was not exempt from usury law and, because it charged usurious interest, the contract was unenforceable.

Liability Issues

Franklin Cap. Funding, LLC v. Austin Bus. Finance, LLC, 2023 WL 3874311 (E.D. Mich. 2023)

A secured party that purchased accounts from a factor, which promised in return not to acquire any further receivables of or accept payment from the debtor, stated claims for breach of contract and conversion against the factor for conducting further business with the debtor through a subsidiary and claims for tortious interference with contract against the subsidiary. The secured party claimed that the factor debited the debtor's deposit account and received payments from the debtor. Even if those actions were taken as a servicer of the subsidiary's factoring transaction, the allegations were sufficient to plead breach of contract. The complaint also sufficiently pled that the subsidiary was an alter ego of the factor by alleging that the two entities share principal offices and staff and do business under the same name, that the subsidiary has no employees of its own but instead relies on the factor's employees to act on the subsidiary's behalf, that the factor's CEO signed the subsidiary's contracts with the debtor, and that the factor and the subsidiary transferred the debtor's funds between one another. The secured party also stated a claim for conversion by claiming that it had a perfected security interest in the funds that the factor received from the debtor.

LENDING, CONTRACTING & COMMERCIAL LITIGATION

Vierig v. Therriault,
2023 WL 4004705 (Utah Ct. App. 2023)
The term in a deed of trust requiring the debtor to pay "all costs and expenses of collection (including Trustee's and attorney's fees in event of default in payment of the indebtedness secured hereby)" was ambiguous as to whether it covered the attorney's fees incurred by the creditor in successfully defending against the debtor's action seeking to invalidate both the deed of trust and the underlying debt. The clause did not cover the attorney's fees the creditor incurred in prosecuting a counterclaim to foreclose on the property and collect the debt because the debtor was not in default and obtained judgment on the counterclaim. As a result, the fees incurred in connection with the counterclaim did not directly lead to the collection of any money owed.

GATX Corp. v. Georgia Power Co.,
2023 WL 3815247 (N.D. Ga. 2023)
A factual question remained about whether the lessee of railcars complied with a requirement of the lease to return the railcars at the end of the lease term in the same operating condition as when initially delivered, ordinary wear and tear excepted. Ordinary wear and tear must not structurally or materially impair the operation of the railcars or exceed the scheduled depreciation of their useful life. The railcars had corrosion and pitting damage and the evidence was contradicting as to whether this damage violated that standard.

Justice Holdings, LLC v. Glade Springs Village Property Owners Ass'n, 2023 WL 4014141 (W. VA. 2023)
Because a homeowner's association may, pursuant to the Uniform Common Interest Ownership Act, terminate without penalty a contract made before the executive board of the association was elected by the unit owners, a homeowner's association could terminate a loan made by the developer to the association at the time the developer controlled the association, and had no liability to repay any portion of the debt. The association could not, however, recapture payments already made.

Kettering Adventist Healthcare v. Jade Designs, LLC,
2023 WL 3978807 (S.D. Ohio 2023)
A supplier that contracted to sell 300,000 3M N93 surgical masks breached by delivering counterfeit goods not manufactured by 3M. Even if the doctrine of substantial performance applies to a contract for the sale to goods, the seller had not substantially performed because the counterfeit masks were not certified by the National Institute for Occupational Safety & Health. The buyer revoked acceptance of the masks within a reasonable time because it sent the seller notification less than six weeks after delivery and less than two weeks after 3M confirmed that the masks were counterfeit. The seller had no right to cure under § 2-508(1) because the time for performance had already expired and no right to cure under § 2-508(2) because it never notified the buyer of its desire to have further time to substitute a conforming tender or that it could have tendered conforming goods. The plaintiff's alternative claims for fraud, negligent misrepresentation, conversion, and unjust enrichment would be dismissed.

Exit Strategy, LLC v. Festival Retail Fund BH, L.P.,
2023 WL 4571932 (Del. Ch. Ct. 2023)
The seller of an option to buy a luxury retail store to a newly formed limited partnership of which the seller became a special limited partner, and which received in exchange both cash and a right to a portion of the proceeds from a future sale of the property, contingent on the amount of the "net return," had no claim against the general partner of the buyer for failure to remit any portion of the future proceeds. The agreement gave the general partner broad discretion to deduct costs incurred when calculating the net return; the general partner owed no fiduciary duties to the seller and the general partner's deductions were governed only by a subjective bad faith standard. The general partner did not violate this standard by deducting the cost of removing a mortgage from the property.

Metropolitan Capital Bank & Trust v. Engstrom,
2023 WL 4234554 (Ill. Ct. App. 2023)
A lender was entitled to summary judgment on its action to collect the full amount owed after the borrower defaulted under a forbearance agreement by failing to pledge specified securities. There was no requirement that breach of the forbearance agreement had to be material and, even if there were, the breach was material even though the securities would have secured a portion of the debt that the borrower paid before the motion for summary judgment was filed. The bank was entitled, upon the borrower's breach of the forbearance agreement, to collect the entire debt; the bank was not limited to damages arising from breach of the forbearance agreement itself.

Hagerty Insurance Agency, LLC v. Luxury Asset Capita, LLC, 2023 WL 4112300 (Colo. Ct. App. 2023)
A pawnbroker that sold a stolen luxury vehicle had not disclaimed the warranty of title by selling the car "as is" because that language disclaims only implied warranties and the warranty of title is not designated as an implied warranty. The pawnbroker also did not disclaim the warranty of title by stating that the sale is made "without any express or implied warranties" because that language was not sufficiently specific. However, summary judgment was inappropriate on whether the warranty of title had been disclaimed by the circumstances of the sale. On the one hand, the buyer knew that the seller was a pawnbroker and the bill of sale identified the previous owner as the seller. On the other hand, the bill of sale was signed by a representative of the pawnbroker (not by the prior owner), the buyer was not shown the certificate of title prior to the sale, and the pawnbroker had told the buyer that the car had "a clean, clear Carfax."

590 Myrtle LLC v. Silverman-Shaw Inc., 185 N.Y.S.3d 655 (Sup. Ct. 2023)
No contract for the sale of real property was formed by the email messages exchanged between the parties' lawyers because the first message sent by the seller's lawyer stated "until you receive fully executed copies, there is no offer or obligation by seller" and that requirement was never waived even though the lawyer later acknowledged receipt of the buyer's deposit.

Magee v. Bunting, 2023 WL 4613793 (Del. Ch. Ct. 2023)
A term in a written lease of farmland prohibiting the tenant from erecting improvements without the landlord's consent and providing that all improvements "shall become" the property of the landlord at the end of the lease term did not cover an irrigation system that the tenant had installed before executing the written lease, while renting the property under an oral lease from the prior owner.

Soaring Pine Cap. Real Estate and Debt Fund II, LLC v. Park St. Group Realty Serv., LLC, 2023 WL 4166576 (Mich. 2023)
Because a usury savings clause nullifies the statutory remedy for usury – which excuses the borrower from paying all interest and fees – such a clause violates public policy and is ineffective if a note, after it is determined which fees should be treated as interest, facially requires the borrower to pay a usurious interest rate, even if the stated interest rate is not usurious. Such a clause might be effective if the interest rate increases above the legal limit after the parties enter into the loan.

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