

CLIENT ALERT

Under New York Law, A Borrower In Distress Is Not Necessarily Under Economic Duress

September 28, 2011

In a recent opinion, the U.S. Court of Appeals for the Second Circuit reinforced a lender's right under New York law to drive a hard bargain when dealing with a commercial borrower in default. See *Interpharm, Inc. v. Wells Fargo Bank, N.A.*, No. 10-1801-cv, 2011 WL 3768827 (2d Cir. Aug. 26, 2011).

Interpharm, the borrower, defaulted on the Credit Agreement governing a revolving line of credit made by Wells Fargo. The parties entered into a series of forbearance agreements. In the forbearance agreements, Wells Fargo, among other things, had reduced the borrowing base calculation and imposed strict conditions and covenants, as well as increased costs. Ultimately, Interpharm ended up selling its assets to pay Wells Fargo. Shortly thereafter, Interpharm repudiated the forbearance agreements (and the releases therein) and sued Wells Fargo for breach of contract and related torts. The district court granted Wells Fargo's motion to dismiss, relying on the releases in the forbearance agreements.

Interpharm appealed the dismissal, arguing that the releases were induced by economic duress. In its complaint, Interpharm alleged that it entered into the forbearance agreements "only because Wells Fargo threatened to continue to wrongfully restrict credit that would have been available to Interpharm had Wells Fargo complied in good faith with its contractual obligations." Slip Op. at 9 (quoting Complaint). "This allegedly left Interpharm with no choice but to agree to the terms of the forbearance agreements or file for bankruptcy, which would have made it 'impossible to continue in business.'" *Id.* (quoting Complaint).

In affirming the district court's dismissal, the Second Circuit confirmed that to avoid a contract under New York law a party must show that the agreement was obtained "by means of (1) a wrongful threat that (2) precluded the exercise of its free will." *Id.* at 12. The Court went on to explain that the principle of duress "extends no further than equity demands. Thus, a mere demonstration of financial pressure or unequal bargaining power will not, by itself establish economic duress. The law demands threatening conduct that is 'wrongful,' i.e., outside a party's legal rights." *Id.* at 13 (internal citations omitted). To be clear, "a threat to withhold performance that one is contractually obligated to provide in order to compel the other party to submit to new demands can constitute a wrongful threat. But a threat to exercise a legal right in pursuit of those same demands cannot." *Id.* (internal citations omitted).

After Interpharm's default, Wells Fargo was no longer obligated to extend credit or to forbear from exercising its rights. Even if Interpharm "had little choice but to agree to the covenants of [the initial forbearance agreement], it was ... because Wells Fargo was otherwise unwilling to forbear from its contract right to terminate the line of credit." *Id.* at 17. Wells Fargo merely drove a hard bargain. Interpharm argued that it had different expectations based on its conversations with Wells Fargo. However, the forbearance agreements contained merger clauses that precluded arguments based on such extrinsic evidence. *Id.* at 18.

As for decreasing the borrowing base, the Credit Agreement gave Wells Fargo "reasonable discretion" to make exclusions from the calculation of the revolving line of credit. Because "reasonable discretion" was not defined in the Credit Agreement, the Court found that the phrase "reasonable discretion is commonly understood to allow a decision maker to choose from a broad

range of choices not conflicting with law or reason." *Id.* at 19. Thus, the Court held that Wells Fargo's decision to adjust the borrowing base calculation did not exceed "the bounds of reasonable discretion." *Id.* at 20. The reduction of the borrowing base, therefore, was not a wrongful threat.

In the end, the Second Circuit's decision validates the principle that lenders may drive hard bargains when their borrowers default. The decision also highlights the importance of knowing the obligations of all parties under loan documents, as well as the significance of releases and merger clauses in forbearance and other loan workout documentation.

For more information, please contact the professional(s) listed below, or your regular Crowell & Moring contact.

Alexis Victoria DeBernardis

Counsel – Washington, D.C.

Phone: +1.202.624.2631

Email: adebernardis@crowell.com