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Something Special

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Don't Be Cruel: Appellate Division Upholds Waiver of Fiduciary Duties But Denies Motion to Dismiss Claim for Breach of Good Faith and Fair Dealing

Can contracting parties waive all common law fiduciary duties? That was one of the questions presented to the New York Supreme Court, Appellate Division, First Department (the "Court") in *111 West 57th Investment LLC, on Behalf of Itself and Derivatively on Behalf of 111 West 57th Partners LLC, et al. v. 111 W57 Mezz Investor LLC, 111 West 57th Partners LLC, et al.* On March 30, 2021, the Court answered in the affirmative and modified the trial court's decision to, among other things, uphold that a waiver of fiduciary duties is enforceable under Delaware law. At the same time, the Court allowed a claim of the Plaintiff (as defined herein) to proceed based on the Defendant's (as defined herein) alleged breach of the duty of good faith and fair dealing as required by the New York Uniform Commercial Code (N.Y.U.C.C. § 1-304).

The case arose from a loan to finance the construction of a luxury condominium project located at 105-111 West 57th Street, New York, New York (the "Property"). The financing consisted of a mortgage and two mezzanine loans totaling an amount up to $725 million. The defendant, 111 W57 Mezz Investor LLC ("Defendant") acquired the $25 million junior mezzanine loan (the "Loan") on June 28, 2017. At the time, the Loan was subject to a forbearance agreement. The forbearance period ended on June 29, 2017 and, a week later, the Defendant issued a notice of "strict foreclosure" to 111 West 57th Sponsor LLC (the "Sponsor"), the managing member of the 111 West 57th Mezz LLC ("Borrower"). After the Sponsor failed to timely object to the strict foreclosure, 111 West 57th Investment LLC (the "Plaintiff") filed an action for a preliminary injunction and temporary restraining order to prevent the Defendant from consummating the foreclosure. The trial court denied the injunction, the Court affirmed the decision and the foreclosure proceeded. On May 14, 2019, the Defendant filed an amended complaint asserting a claim for monetary damages.

Background

The Sponsor and the Plaintiff entered into a joint venture (the "Joint Venture") in June 2013 to acquire and develop the Property. At the time of the strict foreclosure notice, the Joint Venture owned 100% of the equity in the Borrower, which owned 100% of the equity in 111 West 57th Holdings LLC (the "Senior Mezz Borrower"), which in turn owned 100% of the equity in 111 West 57th Property Owner LLC, the owner of the Property (the "Property Owner"). Initially, the Property Owner and the Senior Mezz Borrower obtained loans in the amounts of $400 million and $325 million, respectively. The $325 million loan to the Senior Mezz Borrower was ultimately split into (a) a $300 million loan to the Senior Mezz Borrower, which was secured by the membership interests in the Property Owner (the "Senior Mezz Loan") and (b) a $25 million loan to the Borrower, which was secured by the Borrower's membership interests in the Senior Mezz Borrower (the "Loan").

In January 2017, the lender of the Senior Mezz Loan notified the Senior Mezz Borrower that the Senior Mezz Loan was "out of balance" by $57 million – that is, the costs of completing the construction exceeded the amounts available from the financing. Shortly thereafter, the Senior Mezz Lender made a demand for payment to cure the "out of balance." The Senior Mezz Borrower failed to make the required payment and the parties entered into a forbearance agreement to provide for time to find a new lender or equity partner. The forbearance period ultimately ended on June 29, 2017 without an infusion of additional capital. As the subordinate lender, the Defendant moved quickly to protect its collateral and issued a default notice on the same day that the forbearance period ended.

Strict Foreclosure

After the Borrower did not cure the default, the Defendant issued a notice of a strict foreclosure to the Borrower and the Sponsor in accordance with the applicable loan documents and the Uniform Commercial Code. A strict foreclosure under the UCC permits a lender to accept collateral in full or partial satisfaction of the underlying obligations without the need for judicial action, subject to certain requirements, including the consent of the debtor. In the case of a proposal under which the collateral is transferred in full satisfaction of the debt, the debtor's consent may be deemed to be granted if they do not object within 20 days. In this case, neither the Borrower nor Sponsor objected to the Lender's strict foreclosure proposal, notwithstanding the Plaintiff's insistence that the Sponsor do so. Before the expiration of the 20-day time period, the Plaintiff filed a lawsuit to enjoin the foreclosure. As noted above, the trial court denied the injunction and the Court affirmed the decision of the trial court, and the strict foreclosure was consummated.

Amended Complaint

On May 14, 2019, the Plaintiff filed an amended complaint to asset a claim for monetary damages and alleging a breach of the UCC, a breach of the implied covenant of good faith and fair dealing, conversion, and aiding and abetting a breach of fiduciary duty. The basis of their claims, as noted by the Court, was an allegation that the Defendant had effectively bribed the Sponsor's principals into not objecting to the foreclosure by agreeing that they would be permitted to continue to serve as the construction manager of the project and to have an opportunity to reinvest in the Property post-foreclosure. The Court dismissed all of the Plaintiff's claims other than their breach of good faith and fair dealing claim.

With respect to the Plaintiff's claim for aiding and abetting a breach of fiduciary duty, the Court noted that the limited liability company for the Joint Venture, which governed the relationship between the Sponsor and the Plaintiff, contained a waiver of all fiduciary duties. In dismissing the Plaintiff's claim, the Court implicitly rejected the Plaintiff's contention that the fact that the waiver provision contained an exception for "fraud, intentional misconduct or a knowing and culpable violation of law" meant that there was not a full waiver of all fiduciary duties.

While the Court was persuaded by clear waiver language in the limited liability company agreement for the Joint Venture and the principle under Delaware law that parties can freely waive fiduciary duties by contract, significantly, the Court refused to dismiss the Plaintiff's claim that the Defendant breached its covenant of good faith and fair dealing. The Plaintiff's claim for a breach of the covenant of good faith was rooted in its allegation that the Sponsor's failure to object to the strict foreclosure was the result of a scheme to enrich the principals of the Sponsor at the expense of other members of the Joint Venture. The Court reasoned that because the alleged acts were intentional, bad faith acts, such acts are not subject to the waiver of fiduciary duties and could be a breach of the covenant of good faith and fair dealing.

Conclusion

While the Court's decision provides an affirmation that parties to a limited liability company agreement can effectively waive certain duties (including all fiduciary duties) under Delaware law, it is important for parties to recognize that the covenant of good faith and fair dealing may be breached by intentional acts, notwithstanding express waivers of fiduciary duties. As a lender, actual or alleged breaches of the covenant of good faith and fair dealing can significantly increase enforcement costs.