Contracts Tea no. 6 (August 2011)

New York

Approval of NYSBA's Report on New York Law in International Matters

The New York State Bar Association ("NYSBA") approved a comprehensive report issued by the Task Force on New York Law in International Matters, established October 2010. Among other recommendations and conclusions, the report suggests: (1) establishment of a permanent center in NY for hearings in international arbitration; (2) development of a specialized state court to assist with appropriate international arbitration matters; (3) promotion of both domestic and overseas CLE programs on drafting international agreements primarily for transactional lawyers and in-house counsel; and (4) coordination of the many group and individual efforts to advance NY law and a NY forum for resolving international disputes.[1]

Around the country

More and more courts hold banks accountable for breach of fiduciary duty to their customers. This happens – as in a recent decision of the Court of Appeals of Kansas - when the relationship between bank and customer goes beyond the traditional creditor-debtor and the bank presents itself as its customer's financial advisor.

On July 29, 2011, the Court of Appeals of Kansas held that where a bank holds itself out as the financial advisor of customers and the customers relied on this representation and trusted the bank in the transaction in which they were inexperienced (for example, construction of an office for company operations or swap transactions), then the bank can be held responsible for breach of fiduciary duty. *Bank of America v. Narula* (No. 102,853)

Simplifying the complicated facts of this case, we may say that Sanjiv Narula and Indubala Narula ("the Narulas") were the owners of

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[1] The final report is available at www.nysba.org/InternationalReport.

a successfully growing business named Promotional Resources. From 1993 to 2001, Bank of America ("BOA") handled the Narulas's business and personal financial matters, repeatedly promoting itself as the Narulas's "Trusted Financial Advisor." Charles Wooten ("Wooten") was their "Relationship Manager" at BOA. When the Narulas's business required additional office space, Wooten advised them to construct their own office building, as owning the office space could be an additional source of income for the Narulas after retirement. When the Narulas's told Wooten that they had no experience in building construction or finance, Wooten assured them BOA would "hold their hand" through the entire process. The loan transaction was to be structured as a construction and a permanent loan; the latter had to replace the first once the building was completed.

BOA advised the Narulas to sign a swap interest rate protection agreement, in order to obtain a fixed interest rate, as they wanted. This swap agreement was nonnegotiable, lengthy, pre-printed in small print that was not shown to the Narulas before signing nor was it explained during closing. The Narulas had no idea how the Swap Agreement worked. The Narulas signed three loan agreements: 1) a construction loan for $1,320,000; 2) a permanent loan in the same amount to replace the construction loan when the building was completed; 3) a term Loan for $140,000 for the operation of Promotional Resources during construction. Because the building was not completed, on August 2001, the parties signed a First Modification and Extension Agreement in order to extend the Construction Loan Maturity date to 12/29/01. During this time, however, BOA started having concerns about the Narulas ability to pay back the loans and decided that they had to opt out of the loans and from their obligation to convert the construction loan to a permanent loan. Even if in December all conditions required for conversion of the loan were met, BOA far from converting the loan, contacted the Narulas saying they needed to sign a Second Modification and Extension Agreement or the entire loan would be come due. This second agreement purposefully looked exactly like the first Modification, but for the omission of BOA's obligation to convert the loan and the insertion of a release of claim clause. After they signed this Agreement, the Narulas were advised to seek another lender but were not informed that if they did not find another lender BOA would not convert the loan as originally agreed upon. Because the interest rates had fallen considerably since the original closing, the Narulas willingly tried to find another lender. However, they could not. Besides, the drop in interest rate created a substantial swap agreement termination fee if they went to another lender for a new interest rate.

The Narulas breached their repayment obligation, and on August of 2002 BOA sent a letter of default. In August, 2004 BOA sued to foreclose its commercial mortgage on the building and for the breach of loan agreement. The Narulas counterclaimed for breach of contract, breach of fiduciary duty, breach of the implied duty of good faith and fair dealing, and fraud. The trial court found for the Narulas, awarding over $750k in compensatory damages and over $750k in punitive damages. BOA appealed.

The Court of Appeals held that the Second Modification Agreement was unenforceable because it lacked consideration. The court also held that BOA had defrauded the Narulas because of a clause of the swap agreement[2] and because they induced the Narulas to sign the second agreement without informing them of the change in terms.[3] The court also found for the Narulas on the economic duress count for BOA's threats to foreclose unless the Narulas had signed the Second Modification (in combination with its continuing promise to convert the Construction Loan) creating a coercive situation. Not only: the court also found that BOA also breached the first loan agreement for not converting the loan, and in addition, breached the implied obligation of good faith and fair dealing by omitting to inform the Narulas about the $100,000 Swap Agreement Termination charge and deletion of the conversion clause in the Second Modification.

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[2] In particular, BOA knew at the time of Second Modification agreement that the Narulas were mistaken as to a basic piece of the agreement (i.e. that the swap transaction implied the payment of a termination fee if the Narulas switched to another lender) and had a duty to correct their mistake.

[3] In particular, BOA was also fraudulent in deleting its obligation to convert the loan and in intentionally making the new agreement looking like the first, minus the conversion language.

The most interesting part of the decision, however, is the breach of fiduciary duty. The court noted that the relationship between a bank and its customers is ordinarily one of a creditor-debtor, not a fiduciary one. However, special circumstances may allow for a finding of a fiduciary relationship. The question is "whether a special confidence is placed in one who, in equity and good conscience, is bound to act in good faith and with due regard to the interest of the one placing the confidence." In this case, a special relationship existed because BOA held itself out as the Narulas' "trusted financial advisor." In addition, the Narulas had agreed to construct the building with the understanding that BOA would "hold their hand" through the process and had relied on BOA's advice on the swap agreement. BOA was therefore liable for breach of fiduciary duty.

What is the reach of a forum selection clause contained in a confidential settlement agreement providing "any dispute between the parties "relating to or arising out of" the agreement"? Quite wide, according to a recent decision of the Federal Circuit: the FSC applies if a party interested in enforcing the FSC alleges a license on different patents impliedly arising out of the settlement agreement.

In *General Protecht Group v. Levton Manufacturing* (Federal Circuit, decision No. 2011-1115), issued July 8, 2011, the Federal Circuit affirmed a district court's decision holding a forum selection clause ("FSC") contained in a Confidential Settlement Agreement ("SA") entered into to settle the claims on different patents applicable to the litigation.

Leviton Manufacturing Co., Inc. ("Leviton") and General Protecht Group, Inc. ("GPG")[4] were in the same business of manufacturing ground fault circuit interrupters ("GFCI"). In 2004, they were involved in a dispute filed in District Court in New Mexico with regard to patents no. 558 and 766. The suit was settled in 2007 pursuant to the SA. The SA stated that Leviton would not sue GPG for infringement of patents 588 and 766 in GPG's products currently on

[4] GPG was formerly known as Zhejiang Dongzheng Electrical Co.

the market or in GFCI products that GBG has indicated its intent to market in the U.S. in the future.[5] The SA also contained a "Governing Law/Venue" clause, which stated that any dispute between the parties had to be prosecuted in the district court of New Mexico.[6]

In September 2010, Leviton filed a complaint with the International Trade Commission ("ITC") against GPG alleging infringement of other two patents (124 and 151). Shortly after, Leviton filed a complaint against GPG in the Northern District of California for the infringement of the same two patents. These two patents, in the words of the court, were both "continuations ultimately depending from the applications that issued as the '558 and '766 patents." GPG informed Leviton that it was its understanding that it had a license for the 124 and 151 patents under the SA but that anyway Leviton was required to bring suit in New Mexico pursuant to the FSC. Negotiations failed and GPG brought a declaratory judgment claim for breach of contract, non-infringement, and invalidity and also moved for a temporary restraining order ("TRO") and a preliminary injunction ("PI") against Leviton's litigation outside New Mexico.

The New Mexico district court held that GPG's defense of implied license triggered the FSC. Because the court found that all the factors required for the PI (irreparable harm, balance of hardships, public interest, and likelihood to succeed on the merits) existed, the court granted the PI.

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5 Leviton also hereby covenants not to sue (1) Defendants . . . for alleged infringement of the '558 and/or '766 patents based on the Dongzheng products currently accused of infringement . . . and (2) Defendants . . . for alleged infringement of the '558 patent and/or the '766 patent with respect to an anticipated future new GFCI product that Defendant Dongzheng has indicated its intent to market in the U.S. in the future, provided however that [the future product conforms to a submitted design.]

6 Any dispute between the Parties relating to or arising out of this [Settlement Agreement] shall be prosecuted exclusively in the United States District Court for the District of New Mexico. The Parties consent to the venue and jurisdiction of such court for this purpose.

Leviton, while dropping both the California and the ITC suits, appealed the New Mexico court's decision, contending, among other things, that the SA did not apply here. According to Leviton, the only relationship that the SA bears to the subsequent dispute is that it potentially gives rise to a defense.[7]

The Circuit Court disagreed. The reasoning of the court is the following: the SA provided that "any dispute between the parties relating to or arising out of this agreement shall be prosecuted exclusively in the US District Court of New Mexico." This case presents a dispute regarding the scope of a patent license. GPG alleged that no infringement existed because it had an implied right originated in the SA. The outcome of that dispute will determine whether the patentee can sustain its suit for infringement. Thus, the dispute *did relate to and arise out* of the SA. The FSC contained in the SA applied, and the Court upheld the PI.

[7] Leviton contested the circuit court's decision on two additional grounds: (1) even if the SA would apply, it would not allow for a implied license defense as a matter of law; (2) the lower court erred in the other three preliminary injunction factors.