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Expert Analysis

Ensuring Choice-of-Law Provision Includes Non-Contractual Claims

By **Mitchell J. Geller**

Consider the following scenario: a major bank has recently retained your law firm to recover $100 million due under a credit agreement. The borrowers, a number of Texas corporations, opposing enforcement of the credit agreement have asserted counterclaims for fraud, breach of fiduciary duty, negligent misrepresentation, tortious interference with contract, violation of certain Texas statutes, and other "lender liability" type claims. The bank has advised you that a prominent law firm prepared the credit agreement and underlying loan documents, each of which contains the following choice-of-law provision designating New York law to govern the agreements: "The agreement shall be construed in accordance with and governed by the laws of the State of New York." Assume arguendo that Texas law on "lender liability" type claims is more favorable to a borrower than New York law.

The critical issue is whether the choice-of-law provision in the credit agreement applies to the tort and statutory counterclaims. The answer to this question is crucial to analyzing the validity of the counterclaims and whether a motion to dismiss under Federal Rule 12(b)(6) or CPLR 3211(a)(7) can be made to dismiss any of the counterclaims.

Under New York law, in order for a contractual choice-of-law provision to apply to non-contractual claims, "the express language of the provision must be 'sufficiently broad' as to encompass the entire relationship between the contracting parties."[1] A contractual choice-of-law provision is "sufficiently broad" to cover tort claims (as well as statutory claims) arising from the contractual relationship if it states that "any claim, controversy or dispute arising under or related to this agreement" is governed by New York law or words to like effect.[2] Thus, the mere insertion of these key words should be sufficient to ensure that New York law (or other designated law) will govern tort claims and statutory claims as well as contract claims.

Incredibly, this rule has been in effect for more than a decade. Nevertheless, corporate attorneys continue to rely on "standard" language used in prior agreements that do not contain this critical language. Since the very purpose of a choice-of-law provision designating New York law is to encompass any and all claims, controversies or disputes arising under or related in any manner whatsoever to the agreement or the relationship between the parties, the attorney must draft the provision to ensure this result. The attorney's failure to include the appropriate language in a choice-of-law provision can be devastating to the bank in an action under the credit agreement in two principal respects: (1) it permits the defendants-borrowers to raise claims that are legally insufficient under New York law, but may be valid under the law of the state of the defendants-borrowers: and (2) it substantially increases the legal fees in prosecuting the action on the credit agreement and defending against defendants-borrowers' tort and/or statutory claims.

The issue turns on whether the choice-of-law provision is a broad or a narrow one.

Section 5-1401(1) of the New York General Obligations Law mandates that a choice-of-law provision in a contract involving $250,000 or more designating that New York law governs the parties' rights and obligations shall be given binding effect regardless of whether the contract has a reasonable relation to New York.[3] In the absence of fraud or a violation of public policy, a contract's choice-of-law provision will be enforced.[4]

Scope of Provisions

New York federal and state courts determine the scope of a choice-of-law provision under New York law, the law of the forum, not under the law selected by the provision.[5] The court first must determine whether there is an actual conflict between New York law and the law of the state designated in the choice-of-law provision.[6] No choice of law analysis is necessary where there is no meaningful conflict between the laws of the competing jurisdictions.[7]

The agreement in our scenario contains a choice of law provision that provides that "the agreement shall be construed in accordance with and governed by the law of the State of New York." Although this provision will be enforced with respect to contract claims, New York federal and state cases uniformly hold that such provision will not govern tort claims or statutory claims arising from the contractual relationship.[8]

Finance One Public Co., Ltd. v. Lehman Brothers Special Financing Inc. is the Second Circuit's latest pronouncement on the scope of choice-of-law provisions. There, the court construed a choice of law clause stating that "this Agreement will be governed by and construed in accordance with the laws of the State of New York."[9] It held that this choice of law provision did not apply to tort claims:[10]

> Under New York law, then, tort claims are outside the scope of contractual choice-of-law provisions that specify what law governs construction of the terms of the contract, even when the contract also includes a broader forum-selection clause. See *Krock v. Lipsay*, 97 F.3d at 645 ("Under New York law, a choice-of-law provision indicating that the *contract* will be governed by a certain body of law does not dispositively determine that law which will govern a claim of *fraud* arising incident to the contract."); *Twinlab Corp.*, 724 N.Y.S.2d at 496 (citing *Krock*). Presumably a contractual choice-of-law clause could be drafted broadly enough to reach such tort claims. See *Krock*, 97 F.3d at 645 (stating that a "sufficiently broad" choice-of-law clause would reach claims of tort arising incident to the contract). However, no reported New York cases present such a broad clause.

Capital Z Financial Services Fund II, L.P. v.

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Health Net Inc. is the Appellate Division, First Department's latest decision on the application of a choice-of-law provision to tort claims.[11] The purchase agreement and voting agreement at issue designated that the laws of Delaware "shall govern all issues concerning the validity of this Agreement, the construction of its terms and the interpretation and enforcement of the rights and duties of the parties."[12]

The court held that Delaware law also governed the investors' fraud claim because the "challenged claims here fall squarely within the broad terminology used in the choice of law provision." Specifically, the court held that "all of plaintiffs' claims require 'construction of [the] terms [of the Purchase and Voting Agreement] and the interpretation and enforcement of the rights and duties of the parties [under them].'"[13]

Thus, the issue turns on whether the choice-of-law provision is a broad or a narrow one. Broad choice-of-law provisions apply to disputes "arising out of or relating to" the contract while narrow provisions simply apply to the interpretation of the contract.[14] In the event of a narrow provision,[15] the court will conduct a conflict of law analysis which often will result in the court not applying the law of New York (or the designated state) to the non-contractual claims.

Representative Cases

Winter-Wolff Int'l v. Alcan Packaging Food & Tobacco Inc., an action asserting various contract and tort claims arising out of the termination of a manufacturer's representative agreement, reflects the reluctance of courts to apply a narrow choice-of-law provision to non-contractual claims.[16] There, the provision stated that the "laws of the State of Illinois shall apply and bind the parties to *all questions arising hereunder*."[17]

Relying on *Krock* and *Finance One*, U.S. District Judge Denis Hurley, of the Eastern District of New York, held that the "contractual language 'arising hereunder' is not sufficiently broad to encompass tort claims" because it did not provide that Illinois law applied to "any and all disputes with respect to the parties' dealings."[18] After conducting a choice of law analysis, the court held that New York law governed the tort claims because it "has the greatest interest in regulating this conduct."[19]

In *E*Trade Financial Corp. v. Deutsche Bank, AG*, buyers of a bank's wholly-owned subsidiary and subsidiary's affiliate sued the seller bank for, inter alia, fraud, violation of the California unfair competition law, negligent misrepresentation and breach of contract.[20] Deutsche Bank contended that E*Trade could not assert an unfair competition law claim under Section 17200 of the California Code because the Stock Purchase Agreement (SPA) provided that "[t]his Agreement shall be governed by, and construed in accordance with, the laws of the State of New York." U.S. District Judge Robert Sweet, of the Southern District of New York, rejected Deutsche Bank's contention because the narrow choice-of-law provision applied New York law "for disputes only about the construction or enforcement of the SPA," not to "any actions 'related to' the transaction, such as tort or other claims."[21]

Tort claims also were held outside the narrow choice-of-law provisions in *Longview Equity Fund, L.P. v. iWorld Projects & Systems Inc.* (fraud claim not covered by narrow provision)[22]; *Hughes v. BCI Int'l Holdings Inc.* (claim for violations of the Colorado Securities Act not covered by narrow provision in Bridge Loan Agreements)[23]; *Twinlab Corp. v. Paulson* (provision stating that the "validity, interpretation, construction and performance" of the agreement would be governed by New York law did not preclude assertion of tort cause of action based on Florida's civil RICO Statute)[24]; *Theo Bulmore v. Ernst & Young Cayman Islands* (tort claims arising from the collapse of three hedge funds in an alleged valuation fraud scheme do not fall within choice-of-law provision)[25]; and *Udayan D. Ghose v. CNA Reinsurance Co., Ltd.* (provision does "not extend to the defense of fraudulent inducement" under a directors' and officers' liability insurance policy).[26]

Conclusion

A choice-of-law provision that simply provides that the agreement "shall be construed in accordance with and governed by the laws of the State of New York" will not cover tort claims allegedly arising from the contractual relationship. Tort claims and statutory claims will be covered if the choice-of-law provision states that "this agreement and any claim, controversy or dispute arising under or related to the agreement, the relationship of the parties, and/or the interpretation and enforcement of the rights and duties of the parties will be governed by the laws of the State of New York without regard to any conflicts of law principles" or words to similar effect.

Since the purpose of a choice-of-law provision designating New York law (or other state's law) is to encompass any and all claims, controversies or disputes arising under or related to the agreement or the relationship between the parties, the failure to include such language can be devastating to a client if another state's law applied under a conflicts analysis is materially different from New York law. This unfortunate result can easily be avoided by the use of certain key words in the choice-of-law provision.[27]

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1. *Krock v. Lipsay*, 97 F.3d 640, 645 (2d Cir. 1996) (citing *Turtur v. Rothschild Registry Int'l Inc.*, 26 F.3d 304, 309-310 (2d Cir. 1994)).

2. See *Turtur*, 26 F.3d at 310.

3. See *Philips Credit Corp. v. Regent Health Group Inc.*, 953 F.Supp. 482, 502 (S.D.N.Y.1997).

4. *Hartford Fire Ins. Co. v. Orient Overseas Containers Lines (UK) Ltd.*, 230 F.3d 549, 556 (2d Cir. 2000); *Boss v. American Express Financial Advisors Inc.*, 15 A.D.3d 306, 307, 791 N.Y.S.2d 12, 14 (1st Dep't 2005), aff'd, 6 N.Y.3d 242, 811 N.Y.S.2d 620 (2006).

5. See *Finance One Public Co., Ltd. v. Lehman Brothers Special Financing Inc.*, 414 F.3d 325, 332 (2d Cir. 2005), cert. denied, 584 U.S. 904 (2006); *J.A.O. Acquisition Corp. v. Stavitsky*, 192 Misc.2d 7, 11, 745 N.Y.S.2d 634, 638 (Sup. Ct. New York Co. 2001), aff'd, 293 A.D.2d 323, 739 N.Y.S.2d 821 (1st Dep't 2002) (applying New York law to determine scope of choice of law clause designating New Jersey law).

6. *Matter of Allstate Ins. Co. (Stolarz)*, 81 N.Y.2d 219, 223, 597 N.Y.S.2d 904, 905 (1993).

7. *In re Rezulin Products Liability Litigation*, 390 F.Supp.2d 319, 330 (S.D.N.Y. 2005).

8. See *Finance One*, 414 F.3d at 332-335.

9. Id. at 332.

10. Id. at 335.

11. 43 A.D.3d 100, 840 N.Y.S.2d 16 (1st Dep't 2007).

12. Id. at 109, 840 N.Y.S.2d at 23.

13. Id. (citing *Turtur*). The provision in *Turtur* was a choice-of-law and forum selection provision.

14. In *Finance One* the Second Circuit stated that *Krock* and other courts mistakenly read *Turtur* as applying New York law when, in fact, *Turtur* applied Texas law to determine the scope of the choice-of-law issue. 414 F.3d at 334 & n. 4. Notwithstanding *Finance One's* statement, the courts continue to cite *Turtur* as a leading case on New York choice-of-law issues. See *City of Sterling Heights Police & Fire Retirement System v. Abbey National, PLC*, 423 F.Supp.2d 348, 363 (S.D.N.Y. 2006); *Udayan D. Ghose v. CNA Reinsurance Co Limited*, Index No. 108121/04, at p. 9 (Sup. Ct. New York Co. Jan. 26, 2006) (obtained from WebCivil Supreme).

15. A narrow choice of law provision will encompass a claim for breach of the implied covenant of good faith and fair dealing since this is a "contractual cause of action." See *Comprehensive Habilitation Services Inc. v. Commerce Funding Corp.*, 2009 WL 935665, 9, n. 14 (S.D.N.Y. April 7, 2009). Similarly, a claim for breach of the duty of loyalty in the employer-employee relationship is contractual by nature and thus covered by a choice of law provision. See *FTI Consulting Inc. v. Graves*, 2007 WL 2192200, 10 (S.D.N.Y. July 31, 2007).

16. 499 F.Supp.2d 233 (E.D.N.Y. 2007).

17. Id. at 240 (emphasis added).

18. Id.

19. Id. at 241-243. In the absence of a controlling choice-of-law provision, New York uses an "interest analysis" to determine the law governing a tort claim, under which the law of the jurisdiction having the greatest interest in the litigation is applied. See *White Plains Coat & Apron Co. v. Cintas Corp.*, 460 F.3d 281, 284 (2d Cir. 2006); *Schultz v. Boy Scouts of America Inc.*, 65 N.Y.2d 189, 197, 491 N.Y.S.2d 90, 95 (1985). Thus, under our scenario, defendants-borrowers would argue that Texas law governs the fraud claim since they are Texas corporations, with their principal place of business in Texas, and the alleged loss was sustained in Texas.

20. 420 F.Supp.2d 273 (S.D.N.Y. 2006).

21. Id. at 290.

22. 2008 WL 833230, 7-8 (S.D.N.Y., March 26, 2008).

23. 452 F.Supp.2d 290, 305 (S.D.N.Y. 2006).

24. 283 A.D.2d 570, 724 N.Y.S.2d 496 (2d Dep't 2001).

25. Index No. 104314/05, 2006 WL 4682212, 10-11 (Sup. Ct. New York Co. April 12, 2006).

26. Index No. 108121/04 (Sup. Ct. New York Co., Jan. 26, 2006), at p. 9.

27. There are a few cases decided prior to *Finance One* which held that broad language in a combined choice-of-law and forum selection provision was sufficiently broad to encompass tort claims. See, e.g., *Nanopierce Technologies Inc. v. Southridge Capital Management LLC*, 2002 WL 31819207, at 10 (S.D.N.Y. Oct. 10, 2002) ("courts in the Second Circuit have interpreted the broad language of similar choice-of-law-cum-forum-selection clauses to mandate application of New York law to all claims, including fraud claims arising out of a transaction"). However, broad language appearing in a separate forum selection provision was held not to cover tort claims where the contract contained a narrow choice-of-law provision. See *Williams v. Deutsche Bank Securities Inc.*, 2005 WL 1414435, at 4-5 (S.D.N.Y. June 13, 2005).