

Challenging the Enforceability of a Promissory Note: The Reach and Limits of the ‘Sham’ Exception

'Greenleaf' presents a clear framework for alleging, and demonstrating, a bona fide defense to the enforceability of a promissory note by establishing, through parole evidence, that the actual intent was to never enforce the note at all.

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Commercial real estate transactions, whether financed through traditional commercial lenders, or self-financed by the seller/lender, often involve the buyer's/borrower's execution of a promissory note. A promissory note, in its simplest terms, is a written statement evidencing that money is owed to the seller/lender (the Holder) by the author (the Maker) of the statement. The Holders often agree to make the promissory note because it facilitates the underlying transaction, may be transferred to other people who can then demand payment from the person or entity that originally owed money to them, and most significantly, because the Holder can, presumably, expeditiously enforce the promissory note in court without further evidence of the underlying reason why money was ever owed to the Holder. However, while the Holder may not have to concern itself with the debtor challenging the underlying transaction, courts are often left dealing with attempts to introduce parole evidence to show that the note was not a note at all.

The Motion for Summary of Judgment in Lieu of Complaint and Promissory Notes. To expeditiously enforce the note, the Holder often employs the motion for summary judgment in lieu of complaint, pursuant to CPLR §3213, which like the traditional motion for summary judgment statute (CPLR §3212), provides for an accelerated judgment. However, CPLR §3213 permits a summary judgment motion at the outset of the litigation, without pleadings, and there is no discovery.

In connection with motions made pursuant to CPLR §3213 for summary judgment in lieu of complaint where the instrument at issue is a promissory note, the plaintiff bears the prima facie burden of “proving the *existence* of the subject note and *nonpayment* according to its terms.” *Ro & Ke v. Stevens*, 61 A.D.3d 953 (2d Dep’t 2009) (emphasis added). After a court has found that the subject promissory note was properly signed, delivered, and that no portion of the outstanding balance has been paid, the burden shifts to the defendant to demonstrate a bona fide defense. E.g., *Zyskind v. FaceCake Mktg. Tech.*, 101 A.D.3d 550, 551 (1st Dep’t 2012); *Cutter Bayview Cleaners v. Spotless Shirts*, 57 A.D.3d 708, 710 (2d Dep’t 2008) (“the burden shifts to the defendant to establish, by admissible evidence, the existence of a triable issue with respect to a bona fide defense.”).

Introducing Parole Evidence To Controvert the Note. Under New York law, in the absence of fraud or mutual mistake, generally a party may not offer parole evidence to contradict or modify what appears to be an unambiguous contract. *Marine Midland Bank-S v. Thurlow*, 53 N.Y.2d 381, 387 (1981). However, the parole evidence rule does not bar evidence “to show that a writing, although purporting to be a contract, is, in fact, no contract at all.” *Polygram Holding v. Cafaro*, 42 A.D.3d 339, 340 (1st Dep’t 2007) (quoting *Val-Ford Realty v. J.Z.’s Toy World*, 231 A.D.2d 434 (1st Dep’t 1996)); *Lombardi & Co. v. De La Roche*, 235 A.D.2d 333 (1st Dep’t 1997) (denial of motion for summary judgment in lieu of complaint, upon finding that defendant raised a triable issue “as to whether the instruments were part of a ‘sham’ transaction”); *Dayan v. Yurkowski*, 238 A.D.2d 541 (2d Dep’t 1997) (denying summary judgment and holding that the defendant’s parole evidence should be considered to show that the note, while valid on its face, was not intended to take effect); *Paolangeli v. Cowles*, 208 A.D.2d 1174, 1175 (3d Dep’t 1994). In other words, the defendant has a bona fide defense that the note was never meant to be enforced against the defendant.

Greenleaf v. Lachman, 216 A.D.2d 65 (1st Dep’t), app. den., 88 N.Y.2d 802 (1996), is particularly instructive in this regard. In *Greenleaf*, the court examined a promissory note allegedly executed to avoid negative income tax treatment and found an exception to the parole evidence rule to allow admission of parole evidence, not to vary the terms of the writing, but to show that “a writing, although purporting to be a contract, is, in fact, no contract at all.” 216 A.D.2d at 66 (quoting Richardson, Evidence §606 (Prince 10th ed.)). The court found that the parties to the promissory note were identical to the litigants before the court, the beneficiary of the tax scheme had not disappeared from the calculus, there was no third-party estate whose interest is involved, and that enforcement of the note in favor of the plaintiff would, in essence, allow the instigator and sole beneficiary of the initial tax evasion scheme also to reap the financial benefit of the illusory debt. *Id.* Searching the record, including the submitted parole evidence, the court held that enforcement of the note would be in contravention of public policy and granted summary judgment to the defendant. 216 A.D.2d at 66.

Greenleaf articulated the sham exception to the general rule that parole evidence which otherwise may be inadmissible may be proffered to show that the promissory note was not a contract, but rather a sham transaction. To fall within the ambit of the sham exception, the *Greenleaf* court required three conditions: (1) the parties to the initial transaction are identical to the litigants before the court; (2) the beneficiary of the scheme has not disappeared; and (3) there is no third party whose interests are involved. Thus, upon

satisfying these three conditions, one may defend against a promissory note by demonstrating that it was never intended to be enforced and that it was never a note at all. In that regard, outside evidence may be used to show that a writing, such as the sham note, although purporting to be a contract, was in fact no contract at all.

When presented with the sham exception defense, courts will have to further consider and analyze its reach and limits; for example, the applicability of the sham exception outside the context of the tax avoidance scheme and promissory note in *Greenleaf*. Courts have applied the sham exception to a purported agreement to defraud the lessor's construction lender, *Val-Ford Realty v. J.Z.'s Toy World*, supra; a purported note to hide the pre-testamentary nature of a gift, *Dayan v. Yurkowski*, supra; masking corporate compensation as purported loans in the books and records, to appease a corporate parent, *Polygram Holding v. Cafaro*, supra; and purported loan instruments to avoid tax liability, *Coudert v. Hokin*, No. 12 Civ. 0110, 2017 U.S. Dist. LEXIS 227044, at **12-14 (S.D.N.Y. Aug. 23, 2017). As such, the sham exception developed by *Greenleaf* appears to reach any context where the parties had no intention of enforcing the agreement.

The sham exception also has certain limits. First, a defendant cannot rely on mere conclusory and unsubstantiated allegations that the note was never intended to be enforced. *Genger v. Genger*, 123 A.D.3d 445 (1st Dep't 2014). As the *Genger* court held, simply alleging that the notes were executed as "tax planning mechanisms" is insufficient to meet the burden of proof under *Greenleaf*. 123 A.D.3d at 446. Significantly, *Genger* also reiterated the principle that a mere delay in demanding payment fails to establish that the note was not intended to be enforced. *Id.* Second, if admitting the parole evidence of a sham transaction, "would be contrary to law and public policy, such proof would be inadmissible[.]" *Bersani v. General Acci. Fire & Life Assurance*, 36 N.Y.2d 457, 461 (1975). For example, if the original parties to the sham transaction intended to use it to defraud tax authorities, the evader's successor(s) could not later disavow the agreement. *Cooper v. Cooper & Clement*, 198 A.D.2d 812, 813 (4th Dep't 1993); *Bank of Am. Trust & Sav. Assn. v. Gillaizeau*, 593 F. Supp. 239, 243-44, rev'd on other grounds, 766 F.2d 709, 712 (2d Cir. 1985) (citing *Mount Vernon Trust Co. v. Bergoff*, 272 N.Y. 192, 196 (1936)). Third, the principle that parole evidence introduced to show that it was the intention of the parties not to enter into an enforceable agreement is predicated on proof that the whole contract was a nullity, not only certain provisions of it. *Bersani v. General Acci. Fire & Life Assurance Corp.*, supra.

Conclusion

Greenleaf presents a clear framework for alleging, and demonstrating, a bona fide defense to the enforceability of a promissory note by establishing, through parole evidence, that the actual intent was to never enforce the note at all. While *Greenleaf*, together with its foundation and its progeny, limits the reach of the sham exception, it also provides a legally sound vehicle to challenge a note's enforceability.

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