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Alert

New York Supreme Court Upholds Accelerated Enforceability of "Bad Boy" Guaranty in CMBS Case

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On March 8, 2011, Justice Melvin L. Schweitzer of the New York State Supreme Court granted a motion for summary judgment in lieu of complaint filed by UBS Commercial Mortgage Trust 2007-FL1, Commercial Mortgage Pass-through Certificates, Series 2007-FL1 ("UBS"), and Normandy Reston Office LLC ("Normandy," together with UBS, collectively, "Plaintiffs"), enforcing the obligation of Garrison Special Opportunities Fund LP ("Garrison"), the guarantor under a "bad boy" guaranty, to pay the full amount of the outstanding loan after Borrowers (as defined below) filed for bankruptcy protection. Summary judgment in lieu of complaint is an accelerated procedure available in New York that allows a plaintiff to seek summary judgment without the delays caused by filing a complaint as long as the underlying contract at issue is an instrument for the payment of money only. Relying in part on the express terms of the guaranty and the relative sophistication of Garrison, the Court held in pertinent part that (1) a summary judgment motion may be granted to enforce the "bad boy" guaranty even though the guaranty contains provisions that are not directly related to the payment of money, (2) "bad boy" guaranties are not "unenforceable penalties" and (3) enforcing "bad boy" guaranties is not against public policy.

Background
On July 20, 2007, UBS Real Estate Securities Inc. (the "Original Lender") made a $107 million loan (the "Mortgage Loan" [1]) to four limited liability companies: Penzance Cascades North LLC, Penzance Cascades West LLC, Penzance Parkridge Five LLC and Penzance Parkridge Two LLC (collectively, "Borrowers") pursuant to a loan agreement (as amended, the "Mortgage Loan Agreement") and secured by, among other things, a Deed of Trust ("Deed of Trust") encumbering four office buildings in Reston, Va. (the "Properties"). The Mortgage Loan was subsequently assigned by the Original Lender to Plaintiffs. The equity owner of Borrowers also obtained a mezzanine loan in the amount of $31.5 million (the "Mezzanine Loan") secured by a pledge of 100 percent of the membership interests in Borrowers. In December 2007, the Mezzanine Loan was assigned to Garrison.

After Borrowers failed to pay the Mortgage Loan in full on the maturity date, as extended, Garrison asked Plaintiffs to forbear from foreclosing on the Deed of Trust and divesting Borrowers of title to the Properties so that Garrison could foreclose on the membership interests of Borrowers and take control of the Properties. Garrison and Plaintiffs entered into a forbearance agreement (the "Forbearance Agreement") and Plaintiffs agreed to refrain from foreclosing on the Properties until Nov. 1, 2010. The Forbearance Agreement also contemplated that Garrison intended to negotiate a resolution of the Mortgage Loan default with Plaintiffs. As consideration for their forbearance, Garrison executed a "bad boy" springing guaranty (the "Guaranty") whereby Garrison agreed to "irrevocably and unconditionally" guarantee the payment and performance of the

[1] The Mortgage Loan was subsequently divided into two participations, a senior A Note in the amount of $67.5 million and a junior B Note in the amount of $39.5 million (which was assigned to Normandy Reston Office LLC, a Plaintiff).

"guaranteed obligations"[2] under the Mortgage Loan Agreement, to the extent that such obligations arose after Garrison (or its affiliate or designee) acquired all or any part of the ownership interests in Borrowers.

On Nov. 1, 2010, Garrison acquired 100 percent of the ownership interests in Borrowers as the successful bidder at a UCC foreclosure sale for such interests, thus triggering Garrison's obligations under the Guaranty. When negotiation of the Mortgage Loan restructuring between Garrison and Normandy failed[3] and with a foreclosure sale of the Properties scheduled to occur on Dec. 16, 2010, Borrowers voluntarily filed for bankruptcy protection under Chapter 11 of the United States Bankruptcy Code on Dec. 15, 2010. Pursuant to the Guaranty, the outstanding debt under the Mortgage Loan Agreement became fully recourse to Garrison as a result of the voluntary bankruptcy filing. On Dec. 20, 2010, Plaintiffs demanded payment by Garrison.

Motion for Summary Judgment under CPLR 3213

On Dec. 29, 2010, Plaintiffs filed a motion for summary judgment in lieu of complaint arguing that the express terms of the Guaranty were clear: Garrison was liable for the full amount of the Mortgage Loan as a result of the voluntary bankruptcy filing by Borrowers. Plaintiffs argued that summary judgment was appropriate under CPLR 3213[4] because the action was based on the Guaranty — "an instrument for the payment of money only. … "

In response, Garrison argued that the Guaranty (1) is not an instrument for the payment of money "only" because it includes additional obligations unrelated to the payment of money, (2) is an "unenforceable penalty" because it is intended to prevent borrowers from taking certain actions and (3) is against public policy because it induces Garrison to breach its fiduciary duties and impedes commercially desirable real estate finance restructuring.

The Order

In granting Plaintiff's motion, Justice Schweitzer rejected each of Garrison's arguments and noted that the "core question in the case is whether the action is based upon an instrument for the payment of money only and, therefore, entitles plaintiff to bring an action for summary judgment. … "[5] Garrison argued that the Guaranty could not be an instrument for the payment of money only because it contained provisions unrelated to the payment of monetary obligations (*e.g.*, securitization cooperation clauses). Garrison also argued that in order to understand the terms of the Guaranty, reference would have to be made to extrinsic documents, in particular, the Mortgage Loan Agreement and because the Guaranty did not establish all of the payment terms on its face, Plaintiffs did not establish a *prima facie* case sufficient for summary judgment. Justice Schweitzer rejected Garrison's arguments and held that even though the Guaranty contained provisions unrelated to the payment of the money, because these ancillary provisions were not conditions precedent to any payment obligations, the Guaranty was an instrument for the payment of money "only." Further, because a guaranty by definition relates to an underlying obligation, it is not detrimental to Plaintiff's case that the Guaranty refers to an extrinsic document like the Mortgage Loan Agreement.[6]

Justice Schweitzer also dismissed Garrison's assertion that the Guaranty constituted an "unenforceable penalty." According to the Court, Garrison knew the mechanics and purposes of these types of guaranties and "made a decision to take a calculated risk that it could arrange a refinancing of the Properties before being forced by an aggressive lender to initiate a bankruptcy proceeding to protect its economic interests." Further,

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[2] Pursuant to the Guaranty, the "guaranteed obligations" are the obligations or liabilities of Borrowers under Section 11.22 of the Mortgage Loan Agreement (excluding clause (iii), which is related to the breach of certain environmental representations) and include losses suffered by Plaintiffs as a result of a voluntary bankruptcy filing by Borrowers.

[3] According to the Sworn Affidavit of David Moson, managing director of Garrison, during September and October of 2010, extensive negotiations took place between Garrison and Normandy in an attempt to restructure the Mortgage Loan. Negotiations eventually broke down and subsequent settlement and restructuring offers by Garrison were rejected by Normandy. According to Moson, Normandy made "demands that were beyond any reasonably acceptable terms from an economic standpoint." *Affidavit of David Moson* at 4-5

[4] NY CPLR 3213 provides in part that "when an action is based upon an instrument for the payment of money only … the plaintiff may serve with the summons a notice of motion for summary judgment and the supporting papers in lieu of complaint."

[5] *Order* at 1.

[6] *Order* at 5.

the Court explicitly held that "bad boy" guaranties are recognized as "legitimate financing arrangements" with respect to real estate transactions and have been upheld in New York State and federal courts.[7]

The Court was similarly not convinced by Garrison's appeals to public policy. The Court noted that a parent entity guaranteeing the obligations of a corporate subsidiary is often faced with a conflict between the guarantor's personal economic interests and what is in the best interest of its subsidiary.[8] Although the Court acknowledged that an aggressive lender could "hold up" the negotiation of refinancing options for a troubled loan in order to secure a "sweetheart" deal, it concluded that it is not within the purview of the courts to rewrite or interfere with contractual arrangements that are negotiated between sophisticated parties: The "court is an arbiter of commercial disputes, charged with upholding freely entered into contractual arrangements in accordance with common law precedents and the rules of legislative interpretation. It does not have a mandate to rewrite the rules relating to commercial real estate finance. … "[9]

Conclusion

"Bad boy" guaranties are designed to protect lenders by preventing borrowers from taking certain actions in bad faith (*e.g.*, filing for bankruptcy the night before a foreclosure sale). Very few decisions have interpreted, or, as in the instant matter, enforced such agreements. This decision is an express recognition by New York State courts that "bad boy" guaranties may be enforced by the accelerated procedure available under CPLR 3213, which gives lenders an aggressive enforcement mechanism in connection with such guarantees. The decision suggests a "no-nonsense" approach by the courts to such obligations, particularly where sophisticated parties are on both sides of the transaction.

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[7] *Order* at 8-9.

[8] *Order* at 9.

[9] *Order* at 10.