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Appellate Court Ruling in *Destiny USA*: Notes of Caution for Construction Lenders and A Glimmer of Hope

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Introduction

On July 17, 2009, a lower court in Upstate New York granted an injunction mandating that a lender continue to fund a project and granted other relief that sent shivers down the spines of financial institutions. On appeal, a recent decision by the Appellate Division reversing certain of the lower court's rulings has given a glimmer of hope to lenders. Nonetheless, both the lower court decision and the appellate court opinion remain a cautionary tale for lenders and their lawyers in the drafting and enforcement of loan documents and demonstrate the need for consistent vigilance when following a course of conduct with a borrower that the lender believes is in default.

Background

In July of this year, the Supreme Court for the State of New York, Onondaga County made a ruling in *Destiny USA Holdings, LLC v. Citigroup Global Markets Realty Corp.*[1] that had important implications for lenders in terms of the risks posed by ceasing to fund construction loans in certain circumstances, and practical considerations that lenders and their counsel should keep in mind when drafting loan documents and, performing under those documents. The case also demonstrates the need for lenders to exercise extreme caution when establishing a course of conduct or pursuing workout or enforcement strategies in situations where the lender believes a borrower is in default.

On November 13, 2009, in a 3-2 split decision, the Appellate Division, Fourth Department, New York[2] upheld the lower court's grant of a mandatory preliminary injunction that would require the defendant-appellant construction lender (the "*Lender*") to fund the outstanding draw requests on the construction loan pending the ultimate determination of the rights of the parties. Significantly, the appellate court also ruled that the lower court erred (i) in making rulings for unrequested and inappropriate relief, and (ii) in granting the preliminary injunction without requiring the plaintiff to post an undertaking, the amount of which the appellate court set at $15 million.

The Project and the Loan

The loan in question is a project and construction loan governed by an Amended and Restated Building Loan and Project and Security Agreement (the "*Agreement*"). Under the Agreement, the Lender acted as a funding agent for a pool of funds contributed by the Syracuse Industrial Development Agency (which contributed $170 million) and Destiny USA Holdings, LLC (the "*Borrower*"), which infused $40 million of equity into the project. The Lender agreed to loan an additional

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$155 million toward the project with the understanding that the money advanced by the Lender would be the "last monies" in. The project itself consisted of Phase I of "shopping center/tourist destination" with related facilities (such phase including an initial 800,000 square feet of development) located in Syracuse, New York. The project was heralded as an important public-private partnership which was to incorporate state of the art "green" technology, renewable energy sources and sustainable design. Further, it was expected that the project would create thousands of jobs and otherwise boost the economy of the region.

As the project progressed, the Lender began funding its portion of the project funds by means of monthly advances against draw requests beginning in February, 2007. These advances included not just the direct costs of construction, but also regular interest payments to the Lender. In the summer of 2008, the Lender, while continuing to fund monthly draw requests, issued notices to the Borrower stating that there were "Deficiencies" as that term was defined in the Agreement (i.e. that the loan was "out of balance"), principally because the project budget was not sufficient to pay for tenant improvement costs ("*TI's*"). The parties met to discuss these issues, and for seven monthly draws thereafter, the Lender apparently made advances without including TI's in its calculation of whether a Deficiency existed, and did not otherwise notify the Borrower that a Deficiency existed during that seven-month period. Following receipt of the 27th draw request, however, the Lender served a notice of the existence of a Deficiency (again principally relating to TI's), which would require that the Borrower infuse equity into the project to put the loan back in balance within 10 business days. The Borrower did not provide such an equity infusion. The Lender then issued a default notice and refused to fund two subsequent draw requests. At this point, the Lender had remaining unfunded commitments of approximately $68.4 million.

The Lower Court Case

In early June, 2009 the Borrower instituted an action asserting causes of action for breach of contract, seeking a declaratory judgment, specific performance, and preliminary and permanent injunctions.

To obtain a preliminary injunction, New York law requires that a plaintiff demonstrate (i) a probability of success on the merits in the underlying action, (ii) a danger of irreparable injury if the injunction is not issued, and (iii) a balance of the equities in the plaintiff's favor.[3]

In evaluating whether the Borrower had met the first prong of the test, after careful review of the Agreement, the Court determined that the Borrower had a strong likelihood of success on the merits based upon the exact definitions in the Agreement of "Deficiency", "Plans and Specifications", "Required Improvements", "TI Costs" and related definitions. The court rejected the Lender's position that the budget to be kept in balance was an ever-evolving project budget that included TI's which were not mentioned in the express language of the definition of "Required Improvements" and other related defined terms. The court went on to determine that the Lender's notice of Deficiency was null and void. Worse for the Lender, the court held that because interest was being paid out of the monthly draws, the default and acceleration notices sent by the Lender (which referenced the failure to keep interest payments current) had been sent in bad faith. The court cited the course of conduct between the parties often in determining whether an injunction should issue. In essence, the court ruled that because of the "unambiguous language" of the Agreement there was a likelihood that the Borrower would succeed on the merits.

The court correspondingly disposed of the Lender's claim for anticipatory breach, which the Lender argued was supported by reason of the project not having any committed tenants and thus comprising a "failed project". In effect, the Lender invited the court to read into the Agreement an implied condition to funding that there be no "material adverse change" and then find that the Borrower's failure to find tenants fell within the scope of

such "MAC" provision. This argument was not well received by the court.

With regard to the second prong of the test, the court found that if the Lender failed to fund, a broad range of irreparable injuries -- 17 in all – would result relating to, among other things, the uniqueness of the project, its cutting edge green features, its importance to the community in terms of jobs, revenue and taxes and other economic development benefits, the importance of avoiding a default on the development bond issuance and, importantly, that the current economic financial crisis meant that replacement financing could not be found. It was these factors that appear to have convinced the court that it was equitably empowered to look beyond New York law (including New York case law precedent indicating that specific performance is not a remedy available for the breach of an obligation to fund a loan) to determine that the Borrower had no adequate remedy at law. Finally, the court found that because of the project's uniqueness, its importance to the community and the Lender's conduct, a balancing of the equities weighed in the Borrower's favor.

The court then determined that the Deficiency notice was null and void, that the Lender's default notice was null and void, that the calculation of the Deficiency should not include TI's and that the Lender had breached the Agreement. Based on this, the court ordered that the Lender fund the three outstanding draw requests *and* "pay all future sums due as draws or advances under the [Agreement] as they come due without further delay or interference." Further, the court scheduled a hearing to determine if there was, as of the date of its order, a Deficiency and reserved for that hearing any decision on the nature, amount and type of undertaking to be required of the Borrower.

The Recent Appellate Division Ruling and the Dissent

The Majority

While the majority at the appellate level upheld the lower court's determination that the Borrower was properly entitled to a preliminary injunction requiring funding of pending draw requests by the Lender, it ruled that the lower court erred in granting relief that was not sought by the Borrower and in failing to set an undertaking. The majority also thought that certain relief granted by the lower court was inappropriate – specifically the order that all future draw requests were to be honored without hindrance or interference (impliedly requiring that the Lender fund future draws irrespective of whether the Borrower complied with the terms of the Agreement).

The opinion shows that the majority agreed with the lower court's analysis of the Borrower's likelihood of success on the merits. Further, it cites a plethora of cases for the proposition that the instant case warranted an exception to the general rule in New York that a borrower cannot obtain specific performance on an agreement to lend. The opinion cites "uniqueness" arguments and the argument that replacement financing could not be obtained in support of the lower court's decision that money damages would not be an adequate remedy and that the Borrower would suffer irreparable harm absent injunctive relief. (The court also makes judicial note of harm to the community). Finally, in balancing the equities the court concludes that because of the enormous public interests involved in the project, such a balancing favors the granting of the preliminary injunction.

In the interests of judicial economy (and to avoid sending the case back to the lower court), the Appellate Division ruled that a $15 million undertaking would be a reasonable amount to reimburse the Lender if it was later determined that the preliminary injunction was granted in error.

A Persuasive Dissent

The dissent on appeal is particularly persuasive. The linchpin of the lower court's ruling and the majority's opinion on appeal is that the project's scope and uniqueness somehow coupled with the financial crisis (and the concomitant difficulty in arranging replacement financing) make a contractual default by the Lender incapable of being properly recompensed by money damages.

The dissent, however, points out that the majority cites no controlling authority under New York law that would entitle a party to a preliminary injunction requiring a lending institution to loan money. The dissent attacks the proposition that "cases of construction mortgages are an exception to the rule requiring the party seeking a preliminary injunction to demonstrate irreparable harm." Further, the dissent questions whether the majority's conclusion that enormous potential harm existed is adequately supported by the record. (To the contrary, the dissent asserts that the appellate court should have followed the holdings by the New York Court of Appeals in cases such as *Credit Agricole Indozuez v. Rossiyskiy Kredit Bank*, 94 N.Y.2d 541 (2000), and others which specifically stated the New York rule that mandatory preliminary injunctive relief is *not* available as a remedy where money damages are an adequate remedy, such as where a lender fails to lend).

Following a review of the line of cases cited by the majority in the first section of its argument on irreparable harm (and related footnotes), the authors' view is that the cases cited are weak at best. They include cases on purchase money mortgages tied into purchase contracts where it is well established law that a purchaser of real property may seek specific performance, cases granting specific performance in far different circumstances (i.e. in regard to insurance contract provisions or bond indemnity agreements), and cases from other state or federal jurisdictions involving property in other states. None appear to be cases by which the Appellate Division, Fourth Department would be judicially bound. In more than one instance the dicta of the case cited is relied upon (e.g. *805 Third Ave Co. v. New York Life Ins. Co.*, NYLJ, Sep 22, 1982 at 12 col 1). And astonishingly, none of those cases cited relate to the drastic remedy of a mandatory preliminary injunction requiring a financial institution to fund a loan.

Some Good News for Lenders

Regardless of whether the Destiny USA case is ultimately heard by the New York Court of Appeals,[4] the Appellate Division's ruling should provide some level of encouragement and hope to lenders, albeit small. First, the majority's decision to modify the lower court's ruling pertaining to the honoring of future draw requests is encouraging. Rather than broad relief extending to all future draw requests (as originally conceived by the lower court), the Lender is compelled only to fund the draw requests that were pending at the time the Borrower sought relief. Second, the dissent's arguments are persuasive and provide a potentially useful roadmap for other defendant lenders should a similar fact pattern arise in a different case.

Practical Lessons

Loan Agreement Provisions

An important feature of both the lower court's decision and the appellate court's opinion was the "unambiguous" language of the Agreement. Given the pace at which loan agreements were being documented at the time the project was conceived and the Agreement drafted, the fact that the defined terms in the Agreement purportedly failed to specifically tie TI's into the budget for purposes of calculating a Deficiency may be emblematic of the times. The prevailing workout environment has brought similar issues to the fore. The concepts at issue can be applied both in the current workout environment and in future transactions. If deficiencies in the loan documents are discovered after the original closing, look for an opportunity to address the problem as early as possible (in a short amendment or waiver agreement, for example), preferably before any workout negotiations commence.

First, make sure that defined terms and related schedules and exhibits fit together like a jigsaw puzzle. The budget used to determine whether a loan is in balance must be all-inclusive and fluid so as to encompass modifications for delays, unforeseen conditions and third party controlled items. This is not simply a matter of including references to tenant improvement costs (although that certainly would have helped the Lender in the case at hand). Second, make sure that the approved budget includes (i) all project costs, including all off-site work

required as part of the permitting process, (ii) the costs of bonding such off-site work and any mechanics' liens that may arise in the normal course of a "close out" process, and (iii) an adequate contingency given the state of the plans and specifications at the time the loan agreement is signed. Third, make sure that the definition of "Project" includes the plans and specifications for all features of the project, again, including off-site work; and, if the loan is intended to cover tenant build-out and leasing commissions, for those amounts too. Finally, provide for reserves wherever appropriate and make sure that the loan agreement specifically allows the lender to resize the reserves upon a change in circumstances (such as a delay in the completion date).

Note that an adequate interest reserve in the Destiny USA case could have eliminated some of the arguments of purported bad faith honed in on by the court. Further, a customary TI/LC reserve could have eliminated the controversy over whether TI's were properly included in the Deficiency calculation. Accordingly, lenders should take care to establish critical reserves whenever the economic realities of a project will permit it (either at the inception of the project or as part of a workout).

Perhaps it goes without saying that added attention to, and specificity with regard to, the description of the calculation of "Deficiency" in the Agreement (or similar "short-fall" provisions relating to loan balancing) would have helped the Lender immensely.

Course of Conduct Risks

In the present workout environment, consistent, cautious behavior by lenders is critical. The rulings in the *Destiny USA* case make clear that both the lower and appellate courts were swayed by the Borrower's characterization of the Lender's behavior in first sending notices of Deficiency, next suspending that practice for several months, and then reasserting the existence of a Deficiency thereafter.

When a dispute arises over the terms of a loan agreement, it is often in the best interests of all parties that advances continue to pay valid, budgeted expenses. This is often especially true if the project is nearing completion. Demobilization of a project must be considered warily since remobilization may be cost-prohibitive. With that in mind, any lender which decides to make advances or protective advances in the face of a believed borrower default should send a reservation of rights letter ahead of each such advance, which notes the default thought to exist and reserves all rights. Further, before conducting discussions with the borrower that could be used against the lender in later litigation (as in the instant case where the record suggests that the parties may have orally agreed to omit TI's from the calculation of Deficiencies), it is important to enter into a "pre-negotiation agreement" which makes clear that lender and borrower are having discussions to resolve a dispute or recast the loan, and that none of the discussions may be subject to disclosure or discovery. Further, such an agreement would also state that unless and until a formal written agreement is entered into, the provisions of the loan documents will not be deemed modified.

Finally, once a suit is instituted, it can be advantageous (given the right circumstances) to enter into a "forbearance agreement" whereby the parties mutually agree to suspend litigation and maintain the status quo. This can allow a project to progress free of the distractions of litigation while the parties conduct negotiations. Importantly, once a forbearance arrangement is in place, the risk of a local judge "making an example" of the lender by issuing a highly borrower-friendly decision is greatly diminished. Note that such forbearance agreements may also include provisions that provide the lender with a variety of other benefits, depending on the relative bargaining strengths of the parties and the particular facts at hand.

Conclusion

While the recent appellate court ruling in the Destiny USA case did not reverse the lower court's ruling granting a mandatory preliminary injunction requiring the Lender to fund certain pending draw requests, it did reverse, limit and modify the lower court's ruling in a manner that benefited the Lender to some extent. This is particularly

true when considering the size of the $15 million undertaking required to be posted by the Borrower as part of the injunction (coincidentally, the same amount of the Deficiency claimed by the Lender). A close reading of the lower court's decision and the appellate court's opinion reinforces the need for lenders and their counsel to take great care when interpreting (and, in the first instance, drafting) their loan agreements. Lenders should be similarly cautious when dealing with a borrower a lender believes is in default and should follow a consistent course of conduct at all times. The case may also be a good reminder of the benefits lenders can obtain with the judicious use of reservation of rights letters, pre-negotiation agreements and forbearance agreements in appropriate circumstances.

Endnotes

1 Destiny USA Holdings, LLC v. Citigroup Global Markets Realty Corp., 2009 WL 2163483, 2009 N.Y. Slip Op. 51550(U) (N.Y. Sup. Ct. 2009).

2 Destiny USA Holdings, LLC v. Citigroup Global Markets Realty Corp., 2009 WL 3790441 (N.Y.A.D. 4 Dept.).

3. Aetna Insurance Co. v. Capasso, 75 N.Y.2d 860.

4. On November 23, 2009, the Lender filed a motion for permission to appeal the Appellate Division's decision and order to the New York Court of Appeals.

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