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NY Court Enforces Bankruptcy "Carve-Out" Guaranty on a Non-Recourse Real Estate Loan

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October 2013

A recent New York Supreme Court (trial court) ruling has implications for California borrowers and guarantors. The New York Court upheld a common provision of the recently broadened "carve-out" guaranty by holding that a voluntary bankruptcy filing by the borrower enables the lender to seek immediate full repayment from the guarantor.

The "carve out" guaranty, which allows the lender to demand payment from the guarantor, rather than relying solely on the value of the property securing the loan following a foreclosure, has historically been used only in the event of a certain wrongful ("bad boy") acts by the borrower or guarantor, such as fraud, misappropriation of property income or the non-payment of taxes or other other property obligations. The standard language of the "carve out" guarantee, however, has been broadened in recent times to provide that the guarantee springs into effect creating total liability for the debt if there is a voluntary bankruptcy filing of the borrower; and is no longer measured by the lender's damages from the borrower's or guarantor's fraudulent act or misappropriation of income.

No California court has yet held that the mere filing of a voluntary bankruptcy petition will trigger a guarantee that automatically converts the loan to full recourse against the borrower and springs the guaranty into full recourse against the guarantor. Courts in several additional states, such as New Jersey and Michigan, have already so held. While, historically, California courts have made it very difficult to enforce guarantees on real estate secured loans, it is certainly possible that a California court will now follow the public policy announced in this New York case in which the Court refused to protect the guarantor from such springing liability.

The New York case arises from a foreclosure action brought by a successor to UBS Securities (the "Lender") in the Supreme Court of New York, New York County (Commercial Division) following a Borrower's monetary default on a $29 million non-recourse real estate loan secured by real property in midtown Manhattan (*172 Madison LLC v. NMP-Group LLX, et al.,* Index No. 650087/2010). The Borrower's principal executed a non-recourse carve-out guaranty that, in addition to the standard "bad boy" provisions, also triggered the Guarantor's personal liability for the full amount of the indebtedness to the Lender in the event the Borrower voluntarily filed for bankruptcy protection (the "Guaranty").

Following the monetary default, the Lender commenced a "foreclosure action" which action also contained a cause of action under the Guaranty. The New York Supreme Court (trial court) entered a judgment of foreclosure and sale and the real estate was scheduled for sale. However, an hour before the sale, the Borrower (at the Guarantor's direction) filed a voluntary petition for Bankruptcy in U.S. Bankruptcy Court that automatically stayed the sale. The Lender then filed for summary judgment on the Guaranty alleging that the Guarantor was liable for the full amount of the debt.

The Guarantor defended on the basis that New York's "One Action Rule" (somewhat similar to the law in California) that states that while an action is pending or after final judgment, no other action may be commenced to recover the debt without the permission of the court. The Guarantor argued that the Lender, having elected to obtain a judgment of foreclosure and sale, was required to pursue the elected remedy to its legal conclusion and thus could only opt to seek a deficiency judgment if the foreclosure sale failed to satisfy the entire debt and the Lender could not proceed against the Guarantor under the Guaranty simultaneously.

The Court disagreed with the Guarantor and allowed the Lender to proceed under the Guaranty by granting the Lender's motion for summary judgment on the Guaranty. The Court held that the Lender never "elected a remedy" when it filed for foreclosure because, at that time, liability under the Guaranty had not been triggered by the

Borrower's bankruptcy. The Court held that the "One Action Rule" did not shield the Guarantor from liability for the Borrower's wrongful bankruptcy filing because the doctrine only operates when there was a choice of remedies available at the time the prior action were undertaken. In so holding, the Court provided the Lender with the option to enforce first either the foreclosure judgment or the money judgment under the Guaranty. In reaching its decision the Court said: "…To hold otherwise would undermine the widespread and settled use of nonrecourse loans subject to guaranties triggered by certain springing recourse events. The Court is unwilling to upend the universe of real estate finance for the [Guarantor's] sake."

This decision, especially when considered in the context of other, earlier New York cases dealing with similar issues, is significant for several reasons. In *Bank of America, N.A. vs. Lightstone Holdings, LLC*, July 14, 2011, Case No 601853 and *UBS Commercial Mortgage Trust 2007 FL1 vs. Garrison Special Opportunities Fund L.P.*, March 8, 2011, Case No 652412, the New York courts dismissed arguments that recourse carve-out guaranties violate public policy or are unenforceable penalties. The New York courts ratified the new provision of the carve-out guaranty-that a voluntary bankruptcy filing triggers full recourse.

A number of courts have now rejected the arguments that the springing recourse guaranty violates public policy or constitutes an unenforceable penalty, stating "there is no public policy that would authorize defendants to walk away from their contractual obligations." In each of these cases, the Court found that the defendants, in the guaranty document, had knowingly and explicitly waived the right to raise this defense and that this waiver would be enforced because the defendants were sophisticated real estate investors familiar with these guaranties and the waivers they contained. Further, even if the defense had not been waived, the Court found it to be unavailing because the guaranty was an element of "legitimate financing arrangements with respect to real estate transactions and have been upheld in New York State and federal court."

Borrowers and guarantors, not only in New York, but elsewhere (including California) should take note of these recent decisions. It is now apparent that the courts will take seriously and probably enforce the lender's right to make the loan and the guaranty a full recourse obligation in the event of the borrower's bankruptcy, notwithstanding some strong public policy objections. Moreover, where a clear trigger – such as a voluntary bankruptcy filing – appears in the guaranty, parties should anticipate that the guaranty may be enforced on an expedited basis.