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"Bad Boy" Guaranties and Bankruptcy: New York Court Enforces Non-Recourse Carve-Out Guaranty

A recent New York court decision has cleared the way for lenders to seek recovery against non-recourse carve-out, or "bad boy," guarantors during a pending mortgage foreclosure action if a borrower files for bankruptcy. In so doing, the court answered a question that, surprisingly, was thus far apparently unanswered in a reported decision in New York: whether New York's "one action rule" under RPAPL § 1301 bars a lender from obtaining a money judgment against a "bad boy" guarantor for the debt if a mortgage borrower files for bankruptcy while a foreclosure action is underway. This is a welcomed decision for lenders foreclosing on loans guarantied by non-recourse carve-out guarantors.

The decision arises from the foreclosure action entitled ***172 Madison (NY) LLC v. NMP-Group LLC, et al.***, Index No. 650087/2010, in the Supreme Court of New York, New York County (Commercial Division). In 2007, UBS Securities (with successors, "Lender") made a $29 million non-recourse loan to NMP-Group, LLC ("Borrower"), secured by real property located in midtown Manhattan. The Borrower's principal executed a standard non-recourse carve-out guaranty ("Guaranty"). After the Borrower defaulted, the Lender commenced a foreclosure action, which included a cause of action under the Guaranty. In June 2013, the court entered a judgment of foreclosure and sale in the Lender's favor, and the property was scheduled for sale. But, just an hour before the sale, the Borrower (at the Guarantor's direction) filed a Voluntary Petition for Bankruptcy in U.S. Bankruptcy Court, staying the sale. The Lender immediately filed for summary judgment on the Guaranty, alleging that the Guarantor was liable for the full amount of the debt (in excess of $51 million).

The Guarantor's principal defense was that New York's "one action rule" barred the Lender from pursuing the Guarantor while simultaneously pursuing foreclosure. RPAPL § 1301(3) provides that "[w]hile an action is pending or after final judgment for the plaintiff therein, no other action shall be commenced or maintained to recover any part of the mortgage debt, without leave of the court in which the former action was brought." In that vein, 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 debt, not proceed against the Guarantor under the Guaranty.

The court granted the Lender's motion for judgment on the Guaranty. The court held that the Lender never "elected a remedy" when it filed for foreclosure because, at that time, 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 actions were undertaken." The court based its decision on the fundamental bargain between the Lender and Guarantor:

> Consequently, where, as here, a lender has conditionally agreed to limit its remedies to foreclosure, subject to the borrowing parties' compliance with certain loan covenants, and the borrowing parties breach those covenants only *after* the commencement of foreclosure proceedings, RPAPL 1301 does not preclude the lender from seeking alternate relief at that point, since such relief was unavailable at the time the foreclosure action was commenced . . . . *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 [Guarantor's] sake* (emphasis added).

Consistent with RPAPL § 1301, in deciding in the Lender's favor, the court provided the Lender with the option to enforce first either the foreclosure judgment or the money judgment under the Guaranty and, if the Lender proceeded with the foreclosure judgment, to amend the foreclosure judgment to provide for a deficiency judgment against the Guarantor.

Impact of *172 Madison (NY) LLC*:

The ***172 Madison*** decision clarifies that New York's "one action rule" will not shield a non-recourse carve-out guarantor for intentional "bad acts" taken after the initiation of a foreclosure action. In so doing, the ***172 Madison*** decision provides a foreclosing lender with potential new protections and resolution strategies if a borrower files for bankruptcy during a pending foreclosure and serves as a firm warning to potential borrowers/guarantors who think they can game the system by being a "bad boy." A lender's options in enforcing a judgment against a guarantor in this situation will depend on a number of factors, including the status of the foreclosure action (including whether judgment has been entered), the property's value compared to the debt, the guarantor's financial condition and availability of assets, potential provisional remedies against the guarantor's assets under state law, the lender's goal with respect to the loan (i.e., paid in full or purchase the property), whether the borrower and guarantor are related entities and bankruptcy considerations, such as whether the filing is a single asset real estate case, whether a lift stay motion is feasible and whether there is a cram-down risk to the lender. By way of illustration, if a foreclosing lender obtains judgment against a guarantor, but does not yet have a foreclosure judgment, the lender could enforce the guarantor judgment during the borrower's bankruptcy, which may incentivize the guarantor to timely resolve the matter on favorable terms to the lender. Absent the ***172 Madison*** decision, that same lender may have had to wait until the conclusion of the bankruptcy or foreclosure action before proceeding against the guarantor for any deficiency.

Alston & Bird represented plaintiff 172 Madison (NY) LLC in the litigation.

***This advisory was written by* John Doherty *and* Robert Sullivan.**

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If you have any questions or would like additional information, please contact your Alston & Bird attorney or any of the following:

John P. Doherty
212.210.1282
john.doherty@alston.com

Robert J. Sullivan
704.444.1293
robert.sullivan@alston.com

ALSTON&BIRD LLP

WWW.ALSTONFINANCE.COM

ATLANTA: One Atlantic Center ■ 1201 West Peachtree Street ■ Atlanta, Georgia, USA, 30309-3424 ■ 404.881.7000 ■ Fax: 404.881.7777
BRUSSELS: Level 20 Bastion Tower ■ Place du Champ de Mars ■ B-1050 Brussels, BE ■ +32 2 550 3700 ■ Fax: +32 2 550 3719
CHARLOTTE: Bank of America Plaza ■ 101 South Tryon Street ■ Suite 4000 ■ Charlotte, North Carolina, USA, 28280-4000 ■ 704.444.1000 ■ Fax: 704.444.1111
DALLAS: 2828 North Harwood Street ■ 18th Floor ■ Dallas, Texas, USA, 75201 ■ 214.922.3400 ■ Fax: 214.922.3899
LOS ANGELES: 333 South Hope Street ■ 16th Floor ■ Los Angeles, California, USA, 90071-3004 ■ 213.576.1000 ■ Fax: 213-576-1100
NEW YORK: 90 Park Avenue ■ 12th Floor ■ New York, New York, USA, 10016-1387 ■ 212.210.9400 ■ Fax: 212.210.9444
RESEARCH TRIANGLE: 4721 Emperor Blvd. ■ Suite 400 ■ Durham, North Carolina, USA, 27703-85802 ■ 919.862.2200 ■ Fax: 919.862.2260
SILICON VALLEY: 275 Middlefield Road ■ Suite 150 ■ Menlo Park, California, USA, 94025-4004 ■ 650-838-2000 ■ Fax: 650.838.2001
WASHINGTON, DC: The Atlantic Building ■ 950 F Street, NW ■ Washington, DC, USA, 20004-1404 ■ 202.756.3300 ■ Fax: 202.756.3333
VENTURA COUNTY: 2801 Townsgate Road ■ Suite 215 ■ Westlake Village, California, USA, 91361 ■ 805.497.9474 ■ Fax: 805.497.8804