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When Construction Lenders **Stop Funding**

Borrowers' remedies remain problematic despite 'Destiny' ruling.

BY JANICE Mac AVOY AND DAVID CHARLES POLLACK

IN THE AFTERMATH of the credit crisis, with banks under increasing pressure to reduce their balance sheet exposure, real estate developers continue to face the prospect of lender funding defaults.

As we noted in an earlier article, borrowers who rely upon construction loans to develop real property often are faced with significant obstacles when the lender stops funding and they seek a preliminary injunction to compel their construction lender to advance promised financing in order to keep the underlying development project on track.[1]

Since that time, a divided panel of the Appellate Division, Fourth Department, has become the first court in New York to uphold (in part) a lower court's preliminary injunction for the payment of a construction loan. The decision, *Destiny USA Holdings, LLC v. Citigroup Global Markets Realty Corp.*,[2] is a welcome precedent for real estate developers, because it compelled Citigroup to fund approximately $29 million in pending loan advances for the construction of a shopping center.

In a significant ruling, *Destiny* held that the general rule that injunctive relief is otherwise unavailable on a money contract was overcome where the funding default would have caused "irreparable injury" to an underlying real estate project.

Nevertheless, uncertainties and pitfalls remain for the borrower. Proving irreparable injury to an underlying project can be difficult when alterative sources of financing may arguably be available to keep the project afloat despite the lending default. Also problematic can be the plaintiff's obligation to post a substantial bond even before a preliminary injunction is ordered. Nevertheless, a carefully drafted loan agreement can help deal with both of these problems.

JANICE Mac AVOY *is a litigation partner and* DAVID CHARLES POLLACK *is a litigation associate at Fried, Frank, Harris, Shriver & Jacobson.*

Irreparable Injury

To win a motion for a preliminary injunction, a plaintiff must show that it meets three requirements:

(1) that it will likely prevail on the merits;

(2) that there will be irreparable harm or injury to the plaintiff that cannot be compensated by a monetary damage award absent preliminary relief; and

(3) that a balance of the equities tips in the plaintiff's favor.[3]

Although the first and third requirements may not pose any unique considerations for the real estate borrower,[4] the irreparable injury requirement has posed a difficult hurdle for borrowers seeking to compel their lender to fund.[5]

The failure to pay a specific amount of money is almost definitionally compensable by a monetary award in the same amount, on the theory that all money is fungible.[6] Alternatively, the borrower could obtain alternative financing and be fully compensated by recovery of the additional borrowing costs in a damage award after trial.

Although prior cases had established analogies that could be used by real estate developers to compel funding of a construction loan, the Fourth Department's decision in *Destiny* was a clear departure from the more traditional line of reasoning.

After finding that the borrower had met its burden of establishing that the lender had likely breached its obligation to fund the construction loan, the *Destiny* majority acknowledged that both preliminary injunctive relief and specific performance are usually unavailable on "a pure contract money action."[7]

However, the court recognized, for the first time under New York law, that given exceptional circumstances, where the withholding of promised financing could cause a loss that was not possible to quantify or not curable by an after-the-fact damages payment, injunctive relief is permitted because it is the only way to make the plaintiff whole.[8]

The *Destiny* majority found that the funding default in that case met these exceptional circumstances for three reasons.

First, and most importantly for future construction loan cases, the court held that cases involving construction mortgages are an exception: a construction loan was akin to a contract to sell real property, the loss of which automatically constitutes irreparable harm because of the unique nature of land as an asset, which cannot be properly remedied by money damages.[9]

In a significant extension of prior law, the court held that injunctive relief is available to prevent a lender's breach of a loan agreement that is "an integral part of a contract to sell [or develop] real property" if the failure to fund the loan would harm the underlying project to develop the property.[10]

Destiny's holding on this point elided a distinction that has plagued real estate developers for decades. New York law had previously allowed specific performance only on loans related to the sale of real property, not its development.[11] In *Destiny*, however, the more logical view prevailed: injunctive relief should be available, at least in principle, where it is the only way to protect a plaintiff's interest in an asset like real property that cannot be replaced by money damages.

The second and third reasons the irreparable harm prong was satisfied in *Destiny* also related to the difficulty of quantifying an appropriate damages award, should the funding default bring the underlying project to a halt. The court held that the development project in issue there, which was a "visionary project" reflecting a unique mix of private and governmental funding, designed to be a model of energy efficiency, and otherwise beneficial to the public, was "unique…[in] nature and scope," so that damages could not be calculated with any degree of reasonable precision.[12]

In addition, relying on an affidavit from the plaintiff, the *Destiny* majority found that, if the project were to collapse, the project and the developer itself could potentially suffer reputational harm, traditionally an injury for which damages are insufficient and for which injunctive relief has frequently been held to be appropriate.[13]

Lack of Alternative Funding

However, the simple fact that a loan is tied to real estate or otherwise "unique" does not guarantee the availability of preliminary injunctive relief.

A jilted borrower must also do everything reasonably within its power to avoid irreparable harm to the underlying project, including securing a timely replacement loan, if possible, to save the project. Borrowers may collect damages for any difference in interest rate on the replacement loan,[14] but they may not allow a project to fail and then ask the court to require the lender to pay all damages resulting from the lost project.

In *Destiny*, the majority and the dissent differed markedly on what showing is required in order to demonstrate the unavailability of alternative funding. For the dissent, the plaintiff had failed to establish the lack of other available funds because it did not submit evidence of even an attempt to secure a replacement loan, much less evidence of its diligent search for alternative financing.[15]

For the majority, the plaintiff's decision not to seek a replacement loan was not determinative. Citing cases from the Depression era, the majority took "judicial notice of the economic conditions that prevailed when Citigroup ceased making the loan advances" in May 2009, and deemed them sufficient to establish "a probability" that a replacement loan was unavailable.[16]

Although *Destiny* benefitted from its unique status as an important upstate development project partially funded by public money, a typical plaintiff must carry a heavy burden in attempting to establish irreparable harm.[17] While the *Destiny* plaintiffs were able to carry this burden with an affidavit generally describing the frozen credit market during the credit crisis, a more specific affidavit describing actual steps taken to secure alternative sources of funding is a safer path.[18] An affidavit from the borrower's mortgage broker or financial adviser would be important in establishing the necessary facts.

Posting an Undertaking

Even where a plaintiff can demonstrate irreparable harm and a lack of alternative funding, however, a preliminary injunction will not necessarily issue. CPLR 6312(b) is clear that a plaintiff must post an undertaking "prior to the granting of a preliminary injunction."

While a lower court has discretion in setting the amount, it still must be "rationally related" to the damages recoverable by the defendant if the court's grant of the preliminary injunction is later found to be improvident.[19] However, the bond requirement can create a Catch-22.

For borrowers that are truly in need of the funds their lenders are withholding, it can be impractical, if not impossible, to post the required undertaking. In the experience of the authors, cash-strapped borrowers sometimes choose to abandon the pursuit of a preliminary injunction at the last moment, simply because they are unwilling or unable to post a bond.

Although speculative damages cannot be considered in the setting of a bond,[20] this outer boundary is often of little help to a plaintiff in a construction loan default case, where damages to the lender are typically straightforward. The amount the lender is compelled to pay pursuant to the preliminary injunction, plus interest on that amount, is presumably the damages that would be awarded to the lender if a court were to overturn the preliminary injunction.

In a large construction loan case, this can be quite a substantial sum, as it is what drove the borrower to seek a litigation remedy in the first place.

While a court is unlikely to set such a worst-case-scenario undertaking, a logical, and still quite substantial, bond could be set at the amount of the alleged deficiency, which is often the lender's stated justification for refusing to fund a loan.[21] Overruling the lower court's decision to hold a later hearing on the issue, the *Destiny* panel required the posting of a $15 million bond, approximately the amount by which Citigroup alleged the loan was out of balance.[22]

Thus, unless a plaintiff is indigent or otherwise able to demonstrate extraordinary circumstances,[23] a bond must still be posted. Despite the *Destiny* project's unique circumstances—its partial public funding, its design to benefit the environment and the public—it was still required to post a significant bond.

In a **significant** ruling, 'Destiny' held that the general rule that **injunctive relief** is otherwise unavailable on a money contract was **overcome** where the funding default would have caused '**irreparable injury**' to an underlying real estate project.

Drafting Considerations

Given the hurdles faced by a borrower seeking to compel a defaulting lender to fund, borrowers may attempt to avoid these pitfalls by contracting around the issue. Thus, a loan agreement can provide for specific performance for the borrower upon a lender default without the need to prove the inadequacy of damages.

The loan agreement could set forth the parties' agreement that the lender's breach of its obligations to provide a contracted for advance constitutes irreparable harm, per se, and that money damages would not be an adequate remedy for such a breach.[24]

Depending upon the circumstances of the loan, such a provision could be a reasonable way to eliminate the asymmetry between the power of the lender and the borrower under a typical loan agreement, which provides that the borrower's breach of any of the covenants is an "event of default" entitling the lender to declare the entire balance of the loan immediately due and payable.

Depending on the borrower's negotiating leverage, the requirement to post a bond could be waived by the lender in the loan agreement as well.

Granted, despite recent signs that the credit crisis in commercial real estate has begun to ease, lenders continue to exercise significant bargaining power and it may not be feasible to obtain such concessions. In that case, borrowers faced with a lender default must meet the requirements set forth in *Destiny* to obtain injunctive relief.

1. See Janice Mac Avoy and David Charles Pollack, "When Borrowers Face Lender Funding Defaults," New York Law Journal, Jan. 12, 2009.
2. 889 N.Y.S.2d 793 (4th Dept. 2009). Citigroup has sought leave to appeal to the Court of Appeals, which, as of the writing of this article, had not yet been ruled upon.
3. *Nobu Next Door, LLC v. Fine Arts Housing Inc.*, 4 N.Y.3d 839, 840 (2005); *Bass Bldg. Corp. v. Village of Pomona*, 142 A.D.2d 657, 658 (2d Dept. 1988).
4. But see *805 Third Ave. Co. v. N.Y. Life Ins. Co.*, NYLJ, Sept. 22, 1982, at 12, col. 1 (N.Y. Cty Sup. Sept. 21, 1982) (denying preliminary injunction because court found no likelihood of success on the merits where specific performance was not a recognized remedy for a breach of a mortgage commitment under New York law at the time).
5. *BT Triple Crown Merger Co. Inc. v. Citigroup Global Markets Inc.*, 19 Misc. 3d 1129 (N.Y. Co. 2008).
6. *Credit Agricole Indosuez v. Rossiyskiy Kredit Bank*, 94 N.Y.2d 541, 545 (2000).
7. *Destiny*, 889 N.Y.S.2d at 798.
8. *Destiny*, 889 N.Y.S.2d at 800.
9. Id.; *Randisi v. Mira Gardens Inc.*, 272 A.D.2d 387, 387 (2d Dept. 2000).
10. Id. at 801 (alteration in original).
11. Compare *Bregman v. Meehan*, 125 Misc.2d 332 (Nassau Cty Sup. 1984) (granting specific performance of purchase money mortgage in connection with sale of real estate) and *Leben v. Nassau Sav. & Loan Assn.*, 40 A.D.2d 830 (2d Dept. 1972), aff'd, 34 N.Y.2d 671 (1974) (same) with *805 Third Ave. Co.*, NYLJ, Sept. 22, 1982, at 12, col. 1 (refusing to grant preliminary injunction to compel lender to issue a mortgage on a completed commercial building pursuant to agreed upon mortgage terms). Several cases applying New Jersey law had granted specific performance on loans for the development of real property. See *First Nat'l State Bank v. Commonwealth Federal Sav. & Loan Asso.*, 610 F.2d 164 (3rd Cir. 1979); *Selective Builders v. Hudson City Sav. Bank*, 137 N.J. Super. 500 (1975).
12. *Destiny*, 889 N.Y.S.2d at 801.
13. Id.
14. See *BT Triple Crown Merger Co. Inc. v Citigroup Global Mkts. Inc.*, No. 600899/08, 2008 WL 1970900, at *8-*9 (NY Co. 2008).
15. *Destiny*, 889 N.Y.S.2d at 806 (Fahey, J., dissenting).
16. Id. at 802; see *Blek v. Wilson*, 262 N.Y. 253, 255 (1933); *City of Rochester v. Union Free School*, 255 A.D. 96, 100 (4th Dept. 1938).
17. *Doe v. Alexander*, 73 N.Y.2d 748, 750-51 (1988); *Neos v. Lacey*, 291 A.D.2d 434, 435 (2d Dept. 2002).
18. *Khan v. State Univ. of N.Y. Health Science Ctr. of Brooklyn*, 271 A.D.2d 656, 657 (2d Dept. 2000); *Dubin v. Muchnick*, 87 A.D.2d 508, 508 (1st Dept. 1982); *Village of Honeoye Falls v. Elmer*, 69 A.D.2d 1010, 1010 (4th Dept. 1979).
19. *Lelekakis v. Kamamis*, 303 A.D.2d 380, 380 (2d Dept. 2003).
20. Id.
21. See, e.g., *Destiny*, 889 N.Y.S.2d at 803.
22. Id. at 797, 803.
23. Compare *Pouncy v. Dudley*, 27 A.D.3d 633, 635 (2d Dept. 2006) (fixing an undertaking at $100 because an individual homeowner plaintiff asserted that he was indigent); *Daytop Vill. v. Consol. Edison Co.*, 61 A.D.2d 933, 934 (1st Dept. 1978) (setting the amount of a bond at $1,000 for a nonprofit company running various drug rehabilitation centers) with *Destiny*, 889 N.Y.S.2d at 803.
24. See *Assael v. Assael*, 132 A.D.2d 4, 6, 521 N.Y.S.2d 226, 227 (1st Dept. 1987) (enforcing contract terms allowing, in the event of breach, that "in addition to any other remedies and damages available…the non-breaching party shall be entitled to injunctive relief and the breaching party may be specifically compelled to perform its obligations"); see also *Town of Nassau v. Nalley*, 52 A.D.3d 1013, 1015, 862 N.Y.S.2d 115, 117 (3d Dept. 2008) (affirming lower court's grant of a permanent injunction where it was specified as a remedy in the event of a party breach in the settlement stipulation).