Client Advisory

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Katten Muchin Rosenman LLP

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Destiny v. Citigroup—What It Means for Lenders

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Executive Summary

On July 17, a New York state court issued a mandatory preliminary injunction requiring Citigroup ("Lender") to continue funding a construction and development loan, while declaring null and void the Lender's notices of deficiency and default. The court granted the mandatory preliminary injunction because Destiny USA ("Borrower") was likely to succeed on the merits of its case. The court concluded that the balancing language of the agreement was unambiguous and therefore the loan was not out of balance, so there was no Borrower default.

In light of the court's holdings, it is vital to note that this case is distinguishable for two primary reasons. The first is atmospheric—this case deals with a public works project in which an agency of the City of Syracuse had contributed $170 million prior to loan funding, and it was clear that the court did not want to jeopardize the community investment. Second, the refusal to fund was based on an out-of-balance notice, but the balancing provisions in the Lender's loan documents were very specific, and the court reached its decision based on the narrow and unambiguous definitions within the agreement.

Although the Borrower succeeded in obtaining the preliminary injunction, on July 22 an appeals court judge issued a stay, which puts a temporary hold on the enforcement of the lower court's decision. The order is in effect until August 19, when a full appellate division panel will consider the Lender's motion to stay the proceedings pending a full resolution of the appeal.

Full Summary

IIn this uniquely difficult economic climate, with ever-increasing rates of borrower defaults, lenders are commonly faced with the decision of whether they are contractually obligated to continue funding distressed real estate development projects where the borrower may be in default. *Destiny USA v. Citigroup Global*[1] was one such case where Citigroup ("Lender") sent notice to Destiny ("Borrower") declaring a default and ceased making disbursements. The New York court interpreting the language in the contract held that there was no default, and issued an injunction requiring the Lender to continue disbursing funds pursuant to an Amended and Restated Building Loan, Project Loan and Security Agreement ("Agreement").

[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).

The case involved the Destiny USA mall in Syracuse, New York, a struggling mall project where the Borrower has allegedly failed to lease any space despite already completing over 90% of the construction. The project was initially heralded as an example of an environmentally friendly development that was sure to bring jobs and tax revenue to the surrounding community. The project was a vital redevelopment plan for the city, and as such, the Syracuse Industrial Development Agency committed $170 million of funding. In February 2007, the Borrower and the Lender struck a deal in which the Borrower agreed to invest at least $40 million in equity, and the Lender contracted to lend $155 million and act as the agent for all the construction proceeds (totaling $365 million). For the first 17 construction disbursements there were no problems; but in September 2008 the Lender asserted a "Deficiency" (defined below) under the Agreement. At that time, the Lender started sending out-of-balance notices every month, and in May 2009, after changing legal counsel, the Lender refused to disburse the remaining construction proceeds. As a result, the Borrower filed suit seeking a preliminary injunction requiring the Lender to continue funding the construction project.

In order to obtain a preliminary injunction, a plaintiff must show (1) a probability of success on the merits of an underlying action; (2) a danger of irreparable injury if an injunction is not issued; and (3) a balancing of the equities in the plaintiff's favor.

The court determined that the Borrower would likely succeed on the merits of the claim because, based on the narrow language of the Agreement the Borrower was not in default, and accordingly, the Lender was not entitled to send notice of a default and stop funding the loan. The Lender believed that according to the Agreement, there was a "Deficiency." Pursuant to the Agreement, a Deficiency existed if the project funds to be disbursed were less than the outstanding sums needed to complete the required improvements in accordance with the plans and specifications and fulfill all legal requirements pursuant to the Agreement. The Lender claimed that tenant improvements should be included as part of the balancing equation; thus, there was an approximately $15 million Deficiency, and the failure of the Borrower to deposit this amount with the Lender constituted a default under the Agreement. However, the unambiguous language of the Agreement did not include tenant improvements as part of the loan balancing equation. The Agreement specifically stated that there may be work being performed for or by any tenants that is not being funded from the loan facility proceeds; thus, such sums were not included in the Deficiency equation. The court held that there was no Deficiency according to the unambiguous language of the Agreement, and therefore, there was no default.

In the alternative, the Lender alleged that the Borrower had executed no tenant leases and the project was a complete failure, and as such, the Lender was entitled to anticipatory repudiation based on the project being unlikely to meet a net operating income test in January 2010. The court stated that the Lender's claim was the equivalent of unilaterally rewriting the Agreement, while according to the unambiguous terms of the Agreement, there was no requirement that the project be a success at this stage in the development. As a result of the court's determination that there was no default and the Lender was not entitled to anticipatory repudiation, the court concluded that the Borrower was likely to succeed on the merits of the case.

The court also found that a failure to fund the loan would lead to numerous irreparable injuries and that the balance of the equities was in favor of the Borrower. The court listed 17 ways in which parties would be injured by Lender's failure to fund the loan, including the Borrower being deprived of $68.4 million of financing that could not be replaced in this economic climate, the likely failure of the project, the Borrower's loss of tax credits, the likelihood of municipal bond defaults, job losses in the surrounding community, and millions in lost tax revenues. This was a unique project that had $170 million in public support, and it was clear that the court did not want to jeopardize the community investment.

The court granted the mandatory preliminary injunction requiring the Lender to continue funding the loan because, according to the court, the Borrower was likely to succeed on the merits of its case, there would be irreparable injury if the injunction was not granted, and the balancing of the equities was in the Borrower's favor. In light of the court's holdings, it is vital to note that this case is distinguishable for two primary reasons. The first is atmospheric—this case deals with a public works project in which an agency of the City of Syracuse had contributed $170 million prior to loan funding. Second, the refusal to fund was based on an out-of-balance notice, but the balancing provisions in the Lender's loan documents were very specific, and the court reached its decision based on the narrow and unambiguous language of the Agreement.