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Under Special Circumstances, Court Orders Specific Performance of Construction Lender's Obligations to Fund Advances Pursuant to Construction Loan Agreement

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In *Destiny USA Holdings, LLC v. Citigroup Global Markets Realty Corp*., the New York Supreme Court for Onondaga County held on July 17, 2009 that Citigroup Global Markets Realty Corp. ("Citigroup"), as lender and funding agent pursuant to a 2005 construction loan agreement, must make advances to Destiny USA Holdings, LLC ("Destiny"), the developer of a multi-use project adjacent to Carousel Center Mall in Syracuse, New York. In reaching this decision, the Court emphasized Citigroup's dual role, the "unique" nature of the project, the clarity and unambiguity of the construction loan agreement, and the parties' prior course of dealing. Lenders and their lawyers should be aware of the implications of this decision in negotiating, drafting, performing under, working out, and exercising remedies pursuant to real estate loans.

Background

Destiny sought (i) an order for specific performance, compelling Citigroup to fund construction loan advances in the amount of $68,400,000 or alternatively, (ii) an injunction, enjoining Citigroup from refusing to fund such advances.[1] Citigroup responded that its failure to fund these advances was due to two defaults, both of which were caused by Destiny: (i) a "Deficiency" in the budget (as such term is defined in the construction loan agreement and discussed below), which Destiny failed to cure and (ii) a failure to make the May 2009 interest payment when due and payable. Citigroup also suggested that, as the project is a "failed project" with "no tenants," it should not be forced to fund the advances. The Court, which viewed the project as "the model 'public-private partnership' for economic development, for green development and for sustainable development," dismissed Citigroup's proposal as an attempt to "rewrite" the construction loan agreement.

The project is funded through a combination of sources: Destiny, which invested $40,000,000, the City of Syracuse Industrial Development Agency ("SIDA"), which contributed $170,000,000 and Citigroup, which loaned $155,000,000 pursuant to the construction loan agreement. Citigroup acted as funding agent for all project funds and through the date of the decision, had received payment of substantial fees, interest and other costs.

Citigroup honored the first twenty-six draw requests made by Destiny, while occasionally asserting Deficiencies, making the advances regardless of such alleged Deficiencies and regularly deducting interest payments from each advance pursuant to the terms of the construction loan agreement. However, Citigroup refused to honor Destiny's twenty-seventh draw request due to be paid on May 5, 2009 and issued a Notice of Deficiency for approximately $15,000,000 (the "Deficiency Amount") on May 20, 2009. The Deficiency Amount included $13,500,000 in Tenant Improvement Costs, which the parties had previously agreed would not be included in calculating Deficiencies. It is unclear from the opinion whether the remaining $1,500,000 that was sought to be re-balanced constituted a Deficiency and the opinion does not mention it further.

When Destiny failed to pay both the Deficiency Amount and the interest payment due on May 5, 2009, Citigroup issued a Notice of Default and Acceleration on June 5, 2009. Destiny's subsequent offers to pay the overdue interest on June 6 and 12, 2009 were rejected by Citigroup. Since May, 2009, in addition to the twenty-seventh requested draw, Citigroup refused to fund over $25,000,000 in costs and obligations that had accumulated with respect to the project. Consequently, construction ceased, although the project was estimated to be 90% complete.

In evaluating Destiny's request for a preliminary injunction, the Court analyzed whether Destiny satisfied New York's stated three-prong test, which requires the plaintiff to demonstrate (i) a probability of success on the merits in the underlying actions, (ii) a danger of irreparable injury if the injunction were not issued and (iii) a balance of the equities in the plaintiff's favor – in other words, under the third prong Destiny would need to show that the injury done to it (and the public at large) by Citigroup's failure to fund the advances is greater than the harm that Citigroup would experience by being forced to resume funding (*Aetna Insurance Co. v. Capasso*, 75 N.Y.2d 860).

With regard to the first prong, the Court determined that Destiny had a strong likelihood of success since the method of calculating a Deficiency as described in the construction loan documents depends on the total cost of constructing the Required Improvements in accordance with the Plans and Specifications, and not, as Citigroup contended, on the project's budget at the time of each advance or on costs incurred in connection with Tenant Improvements. Consequently, the Court voided the Notice of Deficiency and Notice of Default and Acceleration, the latter partly in response to its determination that the construction loan agreement (as well as the parties' course of dealing) clearly provided for interest payments to be made out of advances. By refusing to honor the draw request, the Court concluded that Citigroup had acted in bad faith and was at fault for Destiny's failure to make the interest payment on time.

With regard to the second and third prongs, the Court determined that the construction loan agreement explicitly contemplated specific performance or an injunction as the sole remedy for any injury sustained by Destiny should Citigroup unreasonably withhold advances. Moreover, without further advances, the Court found that Destiny would be unable to complete the project and fulfill certain obligations to the City of Syracuse (the "City") and SIDA, including pursuant to two municipal bond issues. In total, the Court enumerated 17 ways in which Destiny, the City, the State of New York, City residents, tenants of the Carousel Center Mall, and bondholders would be adversely impacted if the project is not completed.

Having determined that Citigroup's refusal to fund advances both has caused and will continue to cause irreparable harm, which monetary damages cannot remedy, and that the equities favor Destiny, the Court granted Destiny's request for specific performance and compelled Citigroup to make advances pursuant to the construction loan agreement.

The Court scheduled a hearing for July 28, 2009 to evaluate whether any Deficiency currently exists under the construction loan agreement and whether Citigroup should be required to post a performance bond. The July 28, 2009 edition of the *New York Law Journal* discussed this unreported hearing, noting that the amount of the performance bond was set at $29 million. The journal also noted that Justice Carni of the New York Appellate Division, Fourth Department, issued an unreported order staying the Court's ruling and that this order is expected to be reviewed on August 19, 2009.

Conclusion

The outcome of this case has practical implications for lenders and their lawyers. These include specific drafting issues in loan documentation as well as ways in which lenders may better protect their rights and exercise remedies pursuant to loan agreements.

From a drafting perspective, perhaps had the construction loan agreement employed a more precise method of calculating Deficiencies, Citigroup may have avoided both disputes with Destiny about the existence of Deficiencies and the Court's response to the Notice of Deficiency. For example, the method could have consisted of a line-by-line rebalancing of the budget, rather than an estimate of the difference between the cost of constructing the project in accordance with the original Plans and Specifications and the unfunded balance of the construction loan. This transparent approach could have encouraged the Court to properly evaluate the Notice, which referenced $1,500,000 in costs that were not attributable to Tenant Improvement Costs, rather than postpone a determination of whether a Deficiency existed, and consequently could be recovered by Citigroup, to a later hearing.

Similarly, the construction loan agreement could have indicated clearly and unequivocally that Destiny's obligation to pay interest was independent from its right to borrow pursuant to advances. Although the Court suggested that the construction loan agreement provided for interest to be deducted from advances, it did not quote this language and relied partly on the parties' prior practice in its decision to void the Notice of Default and Acceleration. Finally, the Court may have been more reluctant to dismiss the May 20, 2009 Deficiency if, in connection with previous purported Deficiencies, Citigroup had not subsequently funded advances and/or had issued reservation of rights letters. In sum, this decision suggests that lenders are well advised to both carefully draft and immediately protect their rights under loan agreements and to be mindful as to how their course of dealing while servicing a loan may impact their later remedies under the loan documentation.

Footnotes

[1] Destiny alleged a total of six causes of action, which ranged from the proper interpretation of the default language in the construction loan agreement to the nature and extent of Citigroup's breach.