Litigation Considerations, Part 1: Guaranties — The New York Law Journal

In this first article of her three-part series, Adrienne Koch examines some common aspects of real estate transactions that can benefit from a litigation analysis in the negotiation phase. This article focuses on guaranties.

By Adrienne B. Koch (June 7, 2022)

Parties generally go into real estate transactions with the hope and expectation that the deal (and their relationship) will be a success. Even with the best of initial circumstances, however, it is wise to give some thought to what will happen if the relationship sours – particularly in large or complex transactions. This three-part series will examine some common aspects of real estate transactions that can benefit from a litigation analysis in the negotiation phase, with the first article focusing on guaranties.

A guaranty is an agreement by someone else (the guarantor) to be responsible for some or all of the obligations of a party to a transaction (the primary obligor) if that party fails to perform. Guaranties are typically given by a principal or affiliate of the primary obligor. They are frequently used in real estate transactions, especially where the primary obligor is a single-purpose entity.

A guaranty reduces the counterparty's risk, particularly when the guarantor has a better financial profile than the primary obligor. But by definition, guaranties are only triggered when the primary obligor has defaulted in some way – that is, when something has gone seriously wrong. It therefore pays to analyze at the outset exactly how the guaranty will be enforced if such a triggering event occurs.

One of the ways many guaranties address this is through language waiving a long list of possible defenses. Such language is important, and can even make the obligations of the guarantor more absolute than those of the primary obligor. But other matters that are less commonly considered at the drafting stage can also impact enforcement. Two examples are discussed below.

The scope of the guaranty and its impact on enforcement mechanisms

The scope of a guaranty can impact enforcement in ways the parties may not anticipate. In a very real sense, less may ultimately prove to be more in this regard. Here is why.

The most common kind of obligation for a guaranty to cover is an obligation to pay money. It can be tempting, however, to expand the guaranty to cover other obligations as well. For example, a guaranty of the tenant's obligations under a lease might cover not only its obligation to pay rent, but also non-monetary obligations such as restoring the premises at the conclusion of the lease, providing financial information at certain intervals, or the like. But although a broader guaranty may appear to give the counterparty more protection, in practice it may do the opposite because it can be more difficult to enforce.

The reason for this is because the New York Civil Practice Law and Rules (CPLR) provide a streamlined procedure for the enforcement of "an instrument for the payment of money only." Under CPLR § 3213, such an "instrument" can be enforced through an immediate motion for summary judgment. No complaint is necessary, and the defenses to enforcement are limited. This procedure can greatly expedite the process of obtaining a money judgment on a guaranty.

The procedure is unavailable, however, if the guaranty covers any obligation *other* than the payment of money. This is true regardless of what the beneficiary of the guaranty actually seeks in the litigation: if the guaranty imposes any non-monetary obligations at all, CPLR § 3213 does not apply even if the beneficiary is only seeking to enforce monetary obligations. *See Times Square Associates v. Grayson*, 39 A.D.2d 845 (1st Dept. 1972). In other words, the simple inclusion of non-monetary obligations in a guaranty will mean that even its purely monetary obligations can only be enforced through a plenary action, which will likely include discovery and all of the resulting expense and delay.

Although a guaranty that expressly covers both "payment" and "performance" is generally not eligible for the expedited procedures available under CPLR § 3213, what the guaranty actually does is more important than what it says. If the underlying obligations whose "performance" is guaranteed consist exclusively of obligations to pay money, then CPLR § 3213 will apply. *See 27 West 72nd Street Note Buyer LLC v. Terzi*, 194 A.D.3d 630, 631-32 (1st Dept. 2021), *lv. denied*, 37 N.Y.3d 913 (2021). But if the guaranty includes the word "performance," a party seeking to enforce it may face litigation over whether or not those expedited procedures are available. As a result, if the word "performance" is truly redundant – that is, if the obligations the beneficiary really wants to secure are purely payment obligations – it is much better to specify that the guaranty exclusively covers "payment" and to leave the word "performance" out of the picture altogether.

In some instances, it may be advantageous or even essential to have a guaranty that covers both monetary obligations and non-monetary ones. But any party seeking such a guaranty should give careful thought to the circumstances in which enforcement might become necessary. If the primary concern is monetary, the beneficiary of the guaranty may be better off limiting it to monetary obligations in order to make it easier (and less expensive) to enforce.

<u>The nature and identity of the guarantor</u>

Another important enforcement consideration is just who the guarantor is. Recent events provide an extreme example of the difference this can make: in 2020, New York City enacted (and in 2021 it extended) an ordinance that made personal guaranties of commercial leases permanently unenforceable with respect to any rent arrears that arose between March 7, 2020 and June 30, 2021. This means that if a commercial lease is guaranteed by an individual (rather than by an entity), the landlord has no recourse to the guaranty at all for any arrears that accrued during that period of more than 15 months. This undoubtedly came as an unpleasant surprise to many landlords whose commercial leases were secured by such guaranties.

Although that ordinance was a drastic step taken in response to the COVID-19 pandemic (and a constitutional challenge to it was recently revived and is still being litigated – *see Melendez v. City of New York*, 16 F.4th 992 (2d Cir. 2021)), it highlights how unanticipated changes in circumstances can impact the parties' rights in a long-term relationship. The widespread exigencies created by the pandemic may be unlikely to repeat, but less dramatic changes in circumstance can have equally significant impacts in individual cases. A guarantor's financial profile may change. An entity guarantor may go out of business or otherwise cease to exist, or may undergo a merger or other change that calls into question whether it is the same entity that is named in the guaranty. Such changes could render the guaranty worthless (or substantially less valuable) if the time comes to seek enforcement.

The longer the anticipated relationship, the more attention should be paid to the possibility of such events. Transaction documents can account for this possibility by including such safeguards as periodic reporting or acknowledgements, or providing that the guarantor's failure to maintain a certain financial wherewithal will constitute a default.

The beneficiary of the guaranty should keep in mind, however, that if such provisions are contained in the guaranty itself (rather than in the underlying agreement with the primary obligor) they might prevent it from being treated as an "instrument for the payment of money only" within the meaning of CPLR § 3213. The beneficiary should also do its own due diligence, both by ensuring that the entity named in the final documents is the same entity whose financial information it has reviewed and by periodically checking available public records to make sure there have been no changes to the guarantor's entity status and good standing.

Conclusion

Because resort to a guaranty is generally necessary only when the parties' relationship has not gone the way the transaction documents anticipated, in many instances a guaranty may never again see the light of day after it has been signed. This, of course, is what the parties hope. But if enforcement of the guaranty becomes necessary, the party seeking such enforcement will be in a much better position if careful attention is paid at the outset to how it will work as a practical matter – including what will happen if litigation ensues.

Adrienne B. Koch is a litigation partner with Katsky Korins in New York.