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Client Alert

Financial Institutions Practice

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U.S. Bank, Nat'l Ass'n v. Lightstone Holdings, LLC (N.Y. App. Div. Feb. 14. 2013) -- Senior Lender Gets Second Chance to Assert its Priority Over Mezzanine Lenders With Respect to Guaranty Claim

A recent decision in the protracted litigation by lenders of Extended Stay to recover under guaranties executed by owners of Extended Stay highlights the need for clear and unambiguous drafting in intercreditor agreements. Reversing a trial court holding that the junior lenders had an exclusive right to pursue guaranty claims, the appellate court determined that the applicable language in the intercreditor was ambiguous as to the priority between the senior lender and the mezzanine lenders, and certainly did not support an outright dismissal of the senior lender's claim to recover under the guaranties.

In connection with the financing of its purchase of the Extended Stay hotel businesses, David Lichtenstein and Lightstone Holdings executed non-recourse carve out guaranties with the senior lender and each tranche of the junior mezzanine lenders, obligating them to pay up to $100 million in the event any of the borrowers committed so-called "bad boy" acts, which included the filing of a voluntary bankruptcy petition. The relative rights of the lenders with respect to Extended Stay and the guarantors were set forth in an intercreditor agreement. In June 2009, Extended Stay filed a voluntary bankruptcy petition, triggering the guaranty claims.

The intercreditor agreement provided as follows:

- Section 10(a) provided that all [Junior] Lender rights were subordinate to the Senior Lender's rights, except as otherwise provided in the agreement.

- Section 6(b) provided that "[a]ny right of payment of any [Junior] Lenders under a Guaranty Claim shall be subject and subordinate in all respects to the rights and claims of Senior Lenders . . . against Guarantor . . . except in connection with any [Junior] Lender pursuing its rights under Section 15(q)" of the intercreditor agreement.

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- Section 15(q) provided that "each of the [Junior] Lenders shall have the right to commence and prosecute an action under its respective Guaranty, including without limitation, for up to the full amount of the Guaranty Cap and may apply any amounts recovered, up to its ratable portion, to the balance of its respective Junior Loan."

The junior lenders filed a lawsuit in New York state court to assert their guaranty claims up to the $100 million guaranty cap. Over a year later, the senior lender filed a lawsuit to enforce rights under its guaranty agreement and for declaratory judgment that its rights against the Guarantors were superior to those of the junior lenders.

In September 2011, the trial court ruled that the junior lenders were entitled to assert their guaranty claims. The senior lender argued that all of the junior lenders' rights to the payment were subordinated to the rights of the senior lender, including the right to payment under the guaranty. The trial court disagreed, construing Sections 6(b) and 10(a) to carve out the junior lenders' guaranty claims from the effect of the general subordination language. In so doing, the court noted the prefatory language -- "except as otherwise expressly provided in this Agreement" -- and found that a more specific provision of the intercreditor agreement, Section 15(q), clearly granted the junior lenders the right "to commence and prosecute an action under [their] . . . Guaranty". The trial court went further and found that Section 15(q) of the intercreditor agreement granted to the junior lenders the exclusive right to recover on the guaranties. As a result, it dismissed the senior lender's claims against the guarantors for lack of standing.

On appeal, the appellate court found that the trial court erred in dismissing the senior lender's claim because the language of the intercreditor agreement was ambiguous and, therefore, could not be construed as a matter of law on a motion to dismiss. *U.S. Bank, Nat'l Ass'n v. Lightstone Holdings, LLC*, Case No. 8955-8955A (N.Y. App. Div. Feb. 14. 2013) (citing *China Privatization Fund (Del) L.P. v. Galaxy Entertainment Group LP*., 945 N.Y.S.2d 659 (N.Y. App. Div. 2012)). The court explained that the provisions of the various agreements were not "fully consistent with each other." The court agreed with the trial court that the general subordination provisions did not necessarily apply to the guaranty claims, but disagreed with its conclusion that the provisions were unambiguous. The court first noted that a cardinal rule of contract construction requires the court to avoid an interpretation that would render any clause meaningless. Second, the court found that, since each parties' constructions rendered a portion of the contract superfluous, the contract was ambiguous. Specifically, the court found that, if the junior lenders' theory that Section 15(q) constituted a waiver of the senior lender's rights to any claim on the guaranty cap was correct, the subordination language in Section 6(b) was superfluous. On the other hand, if the senior lender was correct that Section 15(q) applied only to the junior lenders, the language in Section 15(q) allowing the junior lenders to collect on their guaranty claims was superfluous.

In addition, the court disagreed with the trial court's conclusion that the junior lenders had the exclusive right to assert claims against the guaranty cap and, thus, erred in finding that the senior lender lacked standing to assert its guaranty claims. The court thus reversed the trial court's dismissal of the senior lender's claims against the guarantors and remanded the issue as to the senior lenders' assertion of priority over the junior lenders.

Whether the senior lender will ultimately prevail in establishing that the junior lenders' claims are subordinate to its guaranty claim remains to be seen. In the interim, however, this decision illustrates the importance of comprehensive and precise drafting of all provisions of an intercreditor agreement. Clear drafting will ensure that the agreement reflects the parties' intent and can be correctly construed by the court without the need for extrinsic evidence. Specifically, when creating carve-outs from a subordination provision, use of general language, such as "except as

provided in this Agreement," should be avoided in favor of language that clearly defines the particular sections of the agreement intended to be excepted. Moreover, each provision of the intercreditor agreement should be reviewed so there is an unambiguous consistency as to the level of priority afforded particular claims.