HUNTON& WILLIAMS

Client Alert

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On the Horns of a Dilemma: A New York State Trial Court Concludes that Springing Recourse Guaranty Executed by Director Creates Conflict of Interest and Potential Fiduciary Duty Liability

On April 22, 2013, a New York state trial court issued an opinion applying Delaware law and stating that if a director fails to put the corporation into bankruptcy or otherwise delays the bankruptcy filing in order to serve his personal interest, such as to avoid liability under a "springing recourse guaranty," and the corporation's value is diminished as a result, the director might incur uncapped liability for breach of fiduciary duty. *See, Lichtenstein, et. al. v. Willkie Farr & Gallagher LLP, et. al.,* pending in the Supreme Court of the State of New York, County of New York, Index. No. 652092/12 (April 22, 2013). *Lichtenstein* highlights potential risks that may arise for directors and officers when acting in multiple capacities, such as fiduciary and guarantor. Specifically, a director or officer who is a guarantor of the corporation's debt has a conflict of interest in making a decision that would expose such guarantor to liability under that guarantee. When a director has a personal interest, the duty of loyalty is implicated. Moreover, corporate directors cannot be exculpated from personal liability for a breach of the duty of loyalty. Thus, such persons generally should fully disclose their conflicts of interest and abstain from the board's deliberations.

In recent years, it has become increasingly common for commercial real estate lending transactions to include a limited guaranty that imposes liability upon the guarantor in circumstances such as fraud, other "bad acts" or the filing of a voluntary bankruptcy petition. These guarantees are informally referred to as "bad boy" or "springing recourse" guarantees." *Lichtenstein* highlights fiduciary duty issues that may arise for directors of corporations and managers of limited liability companies in situations where lenders have required the fiduciaries to execute springing recourse guarantees where the primary obligor is having financial difficulties, and may possibly file for bankruptcy.

Case Background

In 2007, David Lichtenstein ("Lichtenstein") and others purchased Extended Stay, Inc. ("ESI"), which owned and managed hotels, for approximately $8 billion. After the acquisition, Lichtenstein served as ESI's CEO and was chairman of ESI's board of directors.

In order to finance the acquisition, ESI incurred approximately $4.1 billion in mortgage loan debt and various ESI subsidiaries incurred approximately $3.3 billion in loan debt. Lichtenstein and certain of his affiliates (collectively with Lichtenstein, the "Guarantors") executed springing recourse guarantees that provided for $100 million of liability to the lenders in the event ESI took certain actions within Lichtenstein's control, including the voluntary filing of a bankruptcy petition by ESI.

Soon after the acquisition, the financial crisis occurred and ESI faced a liquidity crisis. ESI retained counsel to advise it with regard to its restructuring efforts and Lichtenstein retained Willkie Farr & Gallagher LLP ("Willkie") to advise him with regard to these same efforts. As the financial condition of ESI continued to decline, ESI's board of directors, including Lichtenstein, was faced with two options: (a) authorize ESI to file for bankruptcy, in which case the springing recourse guarantees would cause

Lichtenstein to be liable to ESI's lenders in the amount of $100 million, or (b) refuse to authorize a bankruptcy filing by ESI, which would allow Lichtenstein to avoid liability on the springing recourse guarantees. Thus, Lichtenstein had a personal interest in the decision whether to authorize ESI to file for bankruptcy.

Lichtenstein alleged that counsel for ESI recommended that ESI file for bankruptcy and advised that ESI's board members, including Lichtenstein, had an obligation as fiduciaries to authorize such bankruptcy. Lichtenstein further alleged that his personal counsel, Willkie, warned him that, as a director and officer of ESI, he risked significant personal liability if he did not authorize the bankruptcy filing by ESI. As ESI's financial condition continued to worsen, Lichtenstein concluded that a bankruptcy by ESI was necessary to preserve the value of ESI and to minimize layoffs of the workforce.

Immediately after ESI filed for bankruptcy, its lenders sued the Guarantors based on the springing recourse guarantees, alleging that because ESI filed for bankruptcy, Guarantors were personally liable in the amount of $100 million.

The Guarantors in turn sued Willkie for legal malpractice, alleging that the firm had failed to properly advise Lichtenstein that he had no risk of liability based upon a claim for breach of fiduciary duty if he refused to consent to ESI filing for bankruptcy to preserve the value of the ESI assets. Willkie filed a motion to dismiss the case for failure to state a claim upon which relief could be granted, which the New York trial court granted.

The Court's Analysis

The trial court applied Delaware law because ESI was organized under Delaware law. Reiterating black letter corporate law, the court noted that directors owe fiduciary duties solely to the corporation and its stockholders. Among the duties a director owes to a corporation is the duty of loyalty which, as the court noted, cannot be reduced, minimized or eliminated by contract. *Lichtenstein,* p. 6. The court stated that under Delaware law, the "classic example" of a breach of the duty of loyalty is a fiduciary who has a conflict of interest or otherwise engages in self-dealing. *Lichtenstein,* p. 7 (*citing, In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 751 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006)). The court further observed that the duty of loyalty "also encompasses cases where the fiduciary fails to act in good faith." *Id. (citing Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006)). Finally, the court noted that under Delaware law, committing waste could be an act of bad faith. *Id. (citing In re Walt Disney Co. Derivative Litig.*, 907 A.2d at 749 and *White v. Panic,* 783 A.2d 543, 553-55 (Del. 2001)).

In the case before the court, Lichtenstein admitted that ESI was insolvent, its financial condition was declining, and filing for bankruptcy was necessary to prevent waste of ESI's assets. Because the bankruptcy was necessary to prevent waste of ESI's assets, Willkie had advised Lichtenstein that he had a fiduciary duty to cause ESI to file for bankruptcy. The court agreed with Willkie's advice. It reasoned that had Lichtenstein failed to cause ESI to file for bankruptcy, or even caused a delay in ESI's filing for bankruptcy in order to avoid personal liability under the springing recourse guaranty, and ESI's value had diminished as a result, he potentially faced uncapped personal liability for breach of fiduciary duty. *Id. (citing In re USA Detergents, Inc.*, 418 B.R. 533, 536-39 (Bankr. D. Del. 2009)). Consequently, the court concluded that the Guarantors failed to state a claim against Willkie and dismissed the malpractice claim.

Conclusion

In the commercial real estate mortgage setting, springing recourse guarantees are very common and have been demanded by lenders to put financial pressure on the principals of the borrower to minimize the risk that the borrower will file for bankruptcy. Thus, in light of the potential liability under the springing recourse guaranty, fiduciaries may have a conflict of interest in determining whether to authorize a borrower to file for bankruptcy.

Lichtenstein should cause fiduciaries who have provided springing recourse guarantees to carefully evaluate the borrower's alternatives. If the filing for bankruptcy is necessary to prevent waste and to preserve value, *Lichtenstein* shows that a fiduciary may become liable for breach of fiduciary duty if he or she fails to cause the borrower to file for bankruptcy to avoid triggering the guarantor's liability on a springing recourse guaranty. If bankruptcy is not pursued in such circumstances, the fiduciaries should carefully document the reasons why they selected a different course of action.

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