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New York's *Lichtenstein* Decision Highlights Conflicts of a Carve-Out Guarantor

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The recent New York case of *Lichtenstein v. Willkie Farr* addresses a borrower's conflict caused, in part, by a loan covenant. The covenant invoked personal liability of the members in the event the entity files a voluntary bankruptcy. The court had to resolve the tension between that provision and an entity's members' fiduciary duty of loyalty precluding "corporate waste" and a member placing their personal interests ahead of the interest of the entity.

In 2007, Lichtenstein, together with other investors, purchased Extended Stay, Inc. (ESI) for $8 billion. The loan documents provided that in the event of a voluntary bankruptcy, Lichtenstein would become a guarantor of the debt up to the sum of $100 million. By late 2008, ESI's financial situation had declined, and it was facing a liquidation crisis. Law Firm A was retained for legal advice on ESI's restructuring efforts. Law Firm A referred Lichtenstein to Law Firm B for advisement on his role as an officer and director of ESI.

ESI's financial situation continued to worsen, and Lichtenstein was advised he had two options:

1. Have ESI file for bankruptcy voluntarily (thus triggering the guaranty agreement and subjecting Lichtenstein to the $100 million liability), or

2. Refuse to authorize the bankruptcy filing, or at least delay it (forcing the lender to petition for involuntary bankruptcy, potentially subjecting Lichtenstein to a breach of fiduciary duty claim). Following Law Firm B's advice, Lichtenstein chose option (1). EIS filed for bankruptcy on June 15, 2009. On June 16th, 2009, the first lender instituted a lawsuit to enforce the $100 million guaranty.

Thereafter, Lichtenstein sued Law Firm B for legal malpractice and breach of fiduciary duty. Lichtenstein argued that:

3. Law Firm B failed to advise him that because the lender insisted that the loan structure include a bankruptcy provision to trigger his personal liability, and then that lender refused to accept the collateral that would have prevented a bankruptcy, that he had no fiduciary duty to cause ESI to file a petition for bankruptcy.

4. Law Firm B had a fundamental self-interest that motivated its advice to him, and that this self-interest should have been, but was not, disclosed. The alleged self-interest was that Law Firm B faced exposure to the lender under an "aiding and abetting" theory if they had advocated a legal justification to Lichtenstein for not putting ESI into bankruptcy.

5. Law Firm B's advice was negligent. According to Lichtenstein, Law Firm B failed to consider that there was no insurance coverage for the $100 million guaranty but that all officers were covered by a $50 million insurance policy which included breach of fiduciary duty. Lichtenstein also alleged that Law Firm B's advice was wrong that the lender would (1) view the filing for bankruptcy "positively", (2) mitigate his personal liability under the guaranty, and (3) not immediately file a lawsuit (when in fact the first one was filed the day after the bankruptcy petition).

Law Firm B moved to dismiss the suit for failure to state a cause of action pursuant to CPLR 3211 (a) (7). Justice Melvin L. Schweitzer granted the defendant's motion. The court found that if Lichtenstein had not followed Law Firm B's advice to authorize a voluntarily petition for ESI's bankruptcy, he would have faced uncapped personal liability for breach of the duty of loyalty to the entity by causing corporate waste, as well as for putting his personal interest ahead of the interest of the entity.

In short, this case highlights the tension (often unacknowledged) between a carveout guarantor's personal financial interests and that guarantor's duties to the borrower entity.