Madison Realty Capital, L.P. v Scarborough-St. James Corp.
2014 NY Slip Op 32082(U)
August 4, 2014
Sup Ct, NY County
Docket Number: 602415/2009
Judge: O. Peter Sherwood
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SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK: COMMERCIAL DIVISION PART 49
--------------------------------------X
MADISON REALTY CAPITAL, L.P. and
67500 SOUTH MAIN STREET RICHMOND LLC,

Plaintiffs,

-against-

SCARBOROUGH-ST. JAMES CORPORATION and
MCANY OF RICHMOND FUND II LIMITED
PARTNERSHIP,

Defendants.
--------------------------------------X

DECISION AND ORDER

Motion Sequence No.: 003
Index No.: 602415/2009

In the Matter of the Arbitration Between:

SCARBOROUGH-ST. JAMES CORPORATION and
MCANY OF RICHMOND FUND II LIMITED
PARTNERSHIP,

Petitioners,

-against-

MADISON REALTY CAPITAL, L.P. and
67500 SOUTH MAIN STREET RICHMOND LLC,

Respondents.
--------------------------------------X

Motion Sequence No.: 001
Index No.: 651469/2014

O. PETER SHERWOOD, J.:

I. BACKGROUND

This dispute arises from an arbitration decision (the "Final Award") issued by Judge Garrett E. Brown (retired) and dated January 27, 2014. The Final Award states that Madison Realty Capital's ("Madison") foreclosing by assignment on a shopping center located in Richmond, Michigan ("the Shopping Center), of which Richmond Realty Limited Partnership ("Richmond") was previously the landlord, did not extinguish the lease ("the Lease") originally formed between Richmond and Scarborough-St. James Corporation ("Scarborough"). The arbitrator held that, Madison is now the landlord and that the annual rent due Madison should be calculated as gross revenues of the Shopping Center minus operating expenses. Scarborough was directed to pay Madison rent for the

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period November, 2008 through December, 2012 in the amount of $652,991.96 plus interest. Rent for periods subsequent to 2012 were to be calculated by the method used in the Final Award to calculate rest due through December, 2012.

Madison filed a motion to confirm the award in this court. Scarborough opposed the motion filed a Cross-Motion to vacate or modify the Final Award. Scarborough claims that Madison should have filed a petition or a special proceeding seeking to confirm the Final Award and that the arbitrator exceeded his authority by issuing a Final Award that imposed obligations on Scarborough, a non-party to the Lease.

A. Background Ownership of the Shopping Center

In 1985, Scarborough acquired a shopping center located at 67300-67500 Main Street, Richmond, Michigan (the "Shopping Center") (Miller Aff. Exhibit L ("Joint Stipulation of Undisputed Facts") ¶ 7). Scarborough acquired the Shopping Center by creating the entities First Richborough Realty Corporation ("FRRC") and Richmond Realty Limited Partnership ("Richmond") (*id.* ¶ 8). After FRRC sponsored private placements and entered into a sale/leaseback with Richmond, Richmond became the owner of the Shopping Center (*id.* ¶¶ 9-10). FRRC took back a promissory note secured by a long term, purchase-money wraparound mortgage from Richmond ("the FRRC Wrap") (*id.* ¶ 12).

Richmond and FRRC then entered into a lease (the "Original Lease"), under which Richmond was the "landlord" and FRRC was the "tenant" (*id.* ¶ 13). Under the Original Lease, Richmond assigned all of the revenues of the Shopping Center to FRRC and FRRC assumed the obligation to pay the Shopping Center's expenses. In 1985, FRRC sold all of its rights associated with the Lease to MCANY I of Richmond Fund Limited Partnership ("MCANYI") (*id.* ¶ 15). FRCC then entered into a long-term servicing agreement with MCANY I (*id.* ¶ 16). In 1994, MCANYI assigned the Lease to MCANY II (*id.* ¶ 17).

B. Bankruptcies of SSJC and FRRC and Creation of the Carmen Loan

In 2003, Scarborough and FRRC were left insolvent after Richmond purported to transfer the Original Lease away from MCANY II on a claim that MCANY II was in default (*id.* ¶ 18). On December 17, 2003, Scarborough and FRRC filed petitions under Chapter 11 of the United States Bankruptcy Code in the United States Bankruptcy Court for the Southern District of New York (*id.*

¶ 20). In early 2004, Scarborough, Richmond and other parties engaged in litigation over the management and control of the Shopping Center (*id.* ¶ 21).

In August 2004, Richmond borrowed $2 million from Carmen LLC, which obtained the money from Warren Bank (the "Carmen Loan"). In exchange, Richmond gave Warren Bank a first mortgage on the Shopping Center (*id.* ¶ 22).

C. The Lease and the Servicing Agreement

On about June 26, 2006, the parties settled the disputes pursuant to a Stipulation Resolving Claims, which provided that Richmond would not refinance or encumber its interests in the Shopping Center without the consent of Scarborough (*id.* ¶ 23). In connection with the Stipulation Resolving Claims, Richmond and MCANY II entered into an Amended and Restated Intermediate Lease (the "Lease"), with MCANY II as tenant and Richmond as landlord (*id.* ¶¶ 25, 27). Further, Richmond and MCANY II agreed to an "Amendment to Amended/Restated Wraparound Mortgage" and an "Amendment to Amended/Restated Wraparound Note" (*id.* ¶ 25).

After entering into the Stipulation Resolving Claims, Scarborough and MCANY II entered into a new "Servicing Agreement," and Scarborough was named the servicing agent (*id.* ¶¶ 27-28). Under the Servicing Agreement, Scarborough was appointed by MCANY II as MCANY II's attorney- in- fact and charged with the collection of rents and performance of the other functions of MCANY II under the Lease (Order at p.1).

D. Richmond's Bankruptcy and DIP Loan

In September 2006, Madison entered into discussions with Scarborough about a possible loan for the intention of satisfying the Carmen Loan and purchasing the Shopping Center (Joint Stipulation of Undisputed Facts ¶ 30). In or around late 2006, however, Warren Bank commenced foreclosure proceedings against Richmond. Richmond subsequently filed for bankruptcy protection (*id.* ¶ 32-33).

Thereafter, Richmond and Scarborough focused on obtaining a DIP (debtor-in-possession) loan for Richmond for the purpose of paying off the Carmen Loan (*id.* ¶ 37). In January 2007, the final loan offer from Madison to Richmond was accepted and signed by Richmond and approved by Scarborough. Pursuant to the DIP Order, Richmond executed and delivered to Madison a promissory note in the original principal amount of $3,100,000.00 (the "DIP Note") (*id.* ¶ 43).

E. Richmond's Default and Madison's Foreclosure

After Richmond failed to repay the principal balance due under the DIP Loan, Madison initiated a foreclosure by advertisement under Michigan law (*id.* ¶¶ 49-50). Two days before the foreclosure sale, in September 2008, Scarborough and Madison entered into an agreement to postpone the sale for four weeks (*id.* ¶¶ 51-52). Pursuant to this agreement, Scarborough executed a waiver, the scope of which is disputed. Scarborough commenced an adversary proceeding in the Bankruptcy Court to enjoin the foreclosure sale, but the Bankruptcy Court declined to stay the sale. Madison foreclosed on the Shopping Center, purchasing the Shopping Center by credit bid (*id.* ¶¶ 53-56).

F. Dispute Over Collecting Rents

After purchasing the Shopping Center, Madison transferred title to the Shopping Center to defendant 67500 South Main Street Richmond LLC ("67500") by quitclaim deed. 67500 represents that it is now the fee simple owner of the Shopping Center (*id.* ¶¶ 57, 60).

On or about April 30, 2009, 67500's management company, Finsilver/Friedman, began contacting tenants at the Shopping Center and directed them to pay rents to 67500. In response Scarborough directed the tenants to continue paying Scarborough (*id.* ¶¶ 61-62). Finsilver/Friedman then changed the locks on vacant tenant spaces. Scarborough responded by changing the locks back (*id.* ¶¶ 63-64).

G. Terms of the Lease

Paragraph 1.01 of the Lease provides:

> The Tenant covenants and agrees to pay to the Landlord an annual rent payment (such sum being called herein "Annual Rent") in the amount of $635,464.08. Notwithstanding anything contained herein to the contrary, Annual Rent for a given year shall never exceed the amount of the Gross Revenues paid by the Subtenants during the corresponding year. . . . In the event Gross Revenues in a give year are less than $635, 464.08, the Annual Rent due for that year shall be adjusted such that the Annual Rent shall be reduced to equal the amount of such Gross Revenues.

Paragraph 1.02 states that:

> Gross Revenues shall count as payment towards the Annual Rent and shall, as soon as is practical after the payment of said Gross Revenues by the Subtenants at the Premises, be reflected on the books and records of the Tenant and Landlord by appropriate debit and credit

> entries, with a corresponding accounting entry being made to reflect payment towards the amount due from Landlord to Tenant on that certain Amended/Restated Wraparound Note dated July 24, 2004. . . .
>
> For the purpose of this Lease, net revenues shall equal Gross Revenues less any operating expenses incurred at the Premises.

(Miller Aff. Exhibit A at ¶¶ 1.01-1.02).

II. PROCEDURAL HISTORY:

A. Justice Yates's Decision

In August 2009, Madison and 67500 commenced a proceeding in this court against Scarborough and MCANY II, seeking an order to stay arbitration and to enjoin Scarborough and MCANY II from interfering with Madison's rights to collect rents at the Shopping Center.

On August 11, 2009, Justice Yates signed an Interim Order which directed the parties to jointly instruct the tenants at the Shopping Center to pay amounts due under their leases to a third party. In a Decision and Order dated, October 21, 2009, Justice Yates determined that the April 20, 2007 DIP Order did not give Scarborough primacy over the Intermediate Lease and denied the injunctive relief requested.

In that Decision and Order, Justice Yates referenced 11 USC 364(d), which states that any primed liens must be granted "adequate protection" and the protection for the Intermediate Lease Interests held by Scarborough were never considered by the Bankruptcy Court (Yates Decision, Judgment, and Order, at 1). He held that the 2007 DIP Order does not grant subordination of the Intermediate Lease, but instead grants "priming liens." In addition, Justice Yates found that the Intermediate Lease only called for Richmond's right to collect rent and that the Intermediate Lease was never the "unencumbered pre-petition and post-petition property of [Richmond]." The purpose of the priming lien, according to Justice Yates, was to "guarantee that none of the other secured parties could make a superior claim against any rents due defendants" (*id.* at 2).

Justice Yates also referred to the DIP Order which provided that "the liens, security interest, and Superpriority Claims granted to the Lender hereunder and in the DIP Loan Documents . . . shall remain binding on all parties-in-interest and shall maintain their priorities as provided in this Interim Order until all DIP Obligations shall have been indefeasibly paid in full and completely satisfied"

(*id.*). Justice Yates continued, stating that "[a]ll DIP Obligations were indefeasibly paid in full and completely satisfied when, at the October 24, 2008 foreclosure sale, plaintiffs bid the amount due in this regard as payment for the Shopping Center title." Finally, Justice Yates concluded that the sale could have no effect on a leasehold interest that is granted prior to the foreclosed mortgage, as was the Intermediate Lease (*id.*). The decision was affirmed by the Appellate Division, First Department (*Madison Realty Capital, LP v Scarborough-St. James Corp.*, 76 AD3d 486 [1st Dept 2010]).

B. The Interim Order Is Vacated

Following the affirmance, Scarborough and MCANY II moved for an order formally vacating the Interim Order. Madison did not object to the request, subject to their claims being heard and decided in the arbitration.

On June 15, 2012, this court granted Scarborough's motion, ordering Tenants at the Shopping Center to pay amounts due under their leases to "Scarborough-St. James Corporation." The court concluded that the Order was without prejudice to Madison's claims which should be finally determined in the arbitration (June 15, 2012 Order, at 2).

C. Arbitration

On November 15, 2013, the arbitrator, issued an Interim Award which held that (1) the Lease involving Scarborough and Madison and 67500 remains valid and enforceable; (2) rent is due to Madison under the Lease; and (3) the proper calculation for net rent due was gross revenues minus operating expenses from the Richmond Kmart Center (Conway Affirm. Exhibit A, at 2). On January 10, 2014, Scarborough submitted a letter seeking to have the method of calculating rent due changed.

In his Final Award, Judge Brown ruled that (1) no modification needed to be made to the Interim Award; (2) the Lease survived the foreclosure and that, as a result, Madison became the landlord under the Lease; (3) the annual rent due Madison should be calculated as gross revenue minus operating expenses; and (4) the Final Award is final and binding (Conway Affirm. Exhibit A at p. 3, 11-16, 21-27, 41). Judge Brown concluded that, "rent is owed to Madison, the present Landlord, under the terms of the Lease . . . . The debt owed by the prior landlord, Richmond, is irrelevant to the current relationship between Landlord and Tenant under the Lease. Similarly, there

is no debt owed by the present Landlord Madison to offset the rent against" (Miller Aff. Ex. H, at 26).

D. The Motions to Confirm, Vacate or Modify the Final Award

On March 6, 2014, Madison filed a Motion to Confirm the Final Award. On April 8, 2014, Scarborough filed opposition and cross-moved to vacate or modify the award (the "Cross-Motion"). Madison filed a reply brief on April 29, 2014.

Scarborough also commenced a separate special proceeding (651469/2014), seeking to vacate or modify the arbitration award—which, according to Madison, is "the exact same relief requested in their Cross-Motion." On May 28, 2014, Madison and 67500 cross-moved for sanctions and to dismiss the petition.

E. Armano's Proposed Intervention

On May 28, 2014, the court received a letter from Thomas Armano, Richmond's general partner (NYSCEF Doc. No. 77). Armano apparently seeks to intervene on Richmond's behalf pursuant to CPLR 7511, although he has not filed a motion seeking that relief. Armano essentially asserts that the Final Order will cause rents otherwise retained by Scarborough, and applied towards the debt owed by Richmond, to be no longer applied to that purpose, thereby harming Richmond.

III. DISCUSSION

A. Armano's Request

Armano's request to intervene is denied, as Armano has no standing to intervene on behalf of Richmond. Initially, because he seeks to represent a corporation, the appearance must be by counsel. Armano claims that he is an interested party, but he was not a part of the arbitration. There is no issue before the court *involving* Armano. Instead, Armano seeks to intervene simply because he believes the ruling will have tax consequences for him. In any event, Armano's arguments were considered and rejected by Judge Brown. In fact, the parties here are asserting Armano's objections.

B. Plaintiffs' Motion to Confirm

CPLR 7502 states that "[n]otwithstanding the entry of judgment, all subsequent applications shall be made by motion in the special proceeding or action in which the first application was made" (CPLR 7502(a)(iii)). The purpose of the amendment to CPLR 7502 is "to clarify what the law was

always meant to do and say: that all arbitration-related applications should be concentrated in a single proceeding or action, to promote judicial economy and prevent forum shopping" (*In re Gleason (Michael Vee)*, 96 NY2d 117, 122-23 [2001]).

The motion to confirm was properly filed in the action commenced in this court in 2009. The action is between the same parties as the Arbitration; (2) this court decided the motion to stay the Arbitration which decision was affirmed on appeal; and (3) this court issued the most recent arbitration related ruling in 2012.

C. Request to Vacate or Modify the Final Award

1. Standard for Vacating or Modifying an Arbitration Award

It is well settled that the scope of judicial review of an arbitration proceeding is extremely limited (*see, e.g., Wien & Malkin, LLP v Helmsley-Spear, Inc.,* 6 NY3d 471, 479 [2006]; *Matter of United Fedn. of Teachers, Local 2, AFT, AFL-CIO v Board of Educ. of City School Dist. of City of N.Y.,* 1 NY3d 72 [2003]; *Elul Diamonds Co. Ltd. v Z Kor Diamonds, Inc.*, 50 AD3d 293 [1st Dept 2008]). CPLR 7510 states "that the court '*shall* confirm an award . . . unless the award is vacated or modified upon a ground specified in section 7511' (emphasis added)" (*Bernstein Family Ltd. Partnership v Sovereign Partners, L.P.*, 66 AD3d 1, 3 [2009]). Accordingly, an arbitrator's award will not be vacated *unless* a party's rights were prejudiced by corruption, fraud or misconduct, bias, excess of power or procedural defects (CPLR § 7511[b] [I-iv]; *see also Geneseo Police Benevolent Assn. v Village of Geneseo* ("[o]nly those grounds for resisting confirmation of an award specified in CPLR 7511 may be the basis for vacating or modifying an arbitration award") 91 AD2d 858, 858 [1982]).

In reviewing an award, the court is bound by the arbitrator's factual findings and interpretations of the contract (*see Matter of New York State Correctional Officers & Police Benevolent Assn. v State of New York*, 94 NY2d 321, 326 [1999]). Even where an arbitrator makes errors of law or fact, a court may not undertake to conform the award "to [its] sense of justice" (id.). An arbitrator's award will be confirmed "if any plausible basis exists for the award "(*see Azrielant v Azrielant*, 301 AD2d 269, 275 [1st Dept 2002] (quoting *Matter of New York State Correctional Officers*, 94 NY2d at 326)). Thus, the party seeking to vacate an award bears a heavy burden (*see Lehman Bros., Inc. v Cox*, 10 NY3d 743 [2008]; *Frankel v Sardis*, 76 AD3d 136 [1st Dept 2010]).

Mere errors of law are insufficient to vacate an arbitration award (*see New York State Correctional Officers*, 94 NY2d at 326).

2. Scarborough's Claim

Defendants principal objections to the Final Award are that (1) the Award suggests that Scarborough has an obligation to pay rent under the Lease even though the only parties to the Lease are allegedly Madison and MCANY II, and (2) the arbitrator calculated the rent due Madison in a way that disregards the clear intent and meaning of the lease.

Defendants do not argue that Scarborough is a party to the lease. Scarborough was the servicing agent and the Lease is binding on only Madison as landlord and MCANY II as tenant. Under the Servicing Agreement, however, Scarborough was assigned to fulfill all of MCANY's II responsibilities and obligations under the Lease. Paragraph 1 of the Servicing Agreement states that:

> [Scarborough] and any successor by merger, transfer, election or otherwise . . . shall, as agent . . . for Fund, collect Gross Revenues, as defined under the Lease and payments due under the Wrap and carry out, execute and fulfill, etc. on the Fund's behalf, all of the Fund's responsibilities and obligations under the lease and Wrap throughout the term of the Lease and Wrap

(Miller Aff. Exhibit B, ¶ 1).

Scarborough, therefore, has control of the Shopping Center under the Servicing Agreement and can collect all rents from subtenants.

It was within the arbitrator's authority to require that the entity empowered by the tenant to collect the rent—Scarborough—pay the rent to the landlord, Madison. As the standard of review of an arbitrator's decision is one of extreme deference (*see Azrielant*, 301 AD2d at 275) the court may not modify the award based on Judge Brown's decision to identify Scarborough as a party to the Lease in the circumstances of this case. The decision of the arbitration did not affect Scarborough's rights by corruption, fraud or misconduct, bias or excess of power. Nor are there any procedural defects. Accordingly, Scarborough has not shown any justification for modifying or vacating the Final Award under CPLR § 7511[b].

The arbitrator found that the Lease was not extinguished as a result of the Madison foreclosure and that Madison must be paid rent under the Lease. Defendants claim, however, that

Judge Brown's interpretation of the Lease disregards the intent of the parties and certain specific language within it. Defendants disagree that the Lease must be modified because Section 1.02 is somehow impractical now that the Landlord is an entity that is not indebted to the Tenant under the Wrap.

The Final Award shall not be modified or vacated, as Judge Brown's interpretation of the Lease did not take him beyond his authority. Judge Brown held that:

> Although the Lease was constructed based upon the financial relationship between Richmond and SSJC, it is not reasonable that SSJC would continue to credit Richmond for rent payments due to Madison while Madison, the current Landlord under the Lease, receives no payments.

In reading that conclusion, Judge Brown looked to Paragraph 1.02, which states that:

> Gross Revenues shall count as payment towards the Annual Rent and shall, as soon as is practical after the payment of said Gross Revenues by the Subtenants at the Premises, be reflect on the books and records of the Tenant and Landlord by appropriate debit and credit entries . . . .

He then decided that, "[t]he unique financing relationship described in Paragraph 1.02 of the Lease is no longer practical because the debt owed by the prior landlord is irrelevant to the current relationship between Madison and MCANY" (Miller Aff. Exhibit H at p. 26).

The court is bound by Judge Brown's interpretation of the Lease (*see Matter of New York State Correctional Officers & Police Benevolent Assn*, 94 NY2d at 326, finding that the court is bound by the arbitrator's interpretations of the contract). An arbitrator's interpretation of a lease will only be vacated or modified if the arbitrator's award "violates strong public policy or is totally irrational" (*see Local 375 v. New York City Health and Hospitals Corp.*, 257 AD2d 530, 532 [1st Dept. 1999]). Judge Brown's interpretation of the Lease does not violate public policy and is not totally irrational. In reaching his decision, he relied on the conclusion reached by the New York Appellate Division, which found that "the DIP Order did not result in the subordination of Madison's interests in the Lease, and the Lease, which was not extinguished by Madison's foreclosure, remains valid and enforceable" (Conway Affirm. Exhibit A. Final Award at p. 13).

The New York Appellate Division in *Madison Realty Capital, LP v Scarborough-St. James*

Corp, 76 AD3d 486, 489-90 [1st Dept 2010] held that:

> The Bankruptcy Court's order, authorizing Richmond to enter into the loan agreement with Madison did not, either expressly or by necessary implication, result in subordination of defendants' interests in the lease and related servicing agreement. As set forth in the motion papers requesting Bankruptcy Court approval pursuant to 1978 Bankruptcy Code (11 USC) § 364, Madison was granted a "superpriority lien" on the shopping center and a collateral assignment and security interest in all "leases, rents, and other income" related to the shopping center (*see* 11 USC § 364 [c], [d]). Consistent with the motion papers, in the order, Richmond's unencumbered "Assets" referred to its right to collect rents through MCANY under the terms of the lease. The order provided "adequate protection" to all prepetition secured lenders, including defendants, whose liens were diminished by the "priming liens" granted to Madison, as set forth in schedule 1 to the DIP motion.

Clearly, the Lease was not extinguished by the Madison foreclosure, and as there is no subordination of interests, rent is owed Madison. To the extent that the foreclosure was "subject to the lease," this only affects the tenants' leasehold interests. The foreclosure cannot alter Madison's priority interest in the rents derived from those leases. Accordingly, the arbitrator did not err in construing the Lease so as to protect Madison's priority. The provision in Paragraph 1.02 of the Lease which provides for Richmond to pay down its debt to Scarborough through accounting entries, makes no sense where Madison is Landlord, and did not assume Richmond's debt to Scarborough.

D. Scarborough's Separate Proceeding and Madison's Cross-motion for Sanctions

Scarborough's separate proceeding seeking to vacate or modify the award will be denied. Prior to the Final Award, Judge Brown directed Madison and Scarborough to meet and confer regarding the final award. The parties failed to do so. Although Madison put forward its arguments in detail prior to publication of the Final Award and Scarborough had an opportunity to rebut them, Scarborough did not confer with Madison. Further, Scarborough made no written submissions to object to Madison's terms.

Madison's cross-motion for sanctions is denied. Judge Brown specifically excluded legal fees in the Final Award. He found that, "the Lease does not provide for and no statute applies allowing recovery of legal fees" (Miller Aff. Exhibit H at p. 31). Finally, the filing of the separate special proceeding, while ultimately unnecessary, was not made in bad faith. Any resulting proceedings were *de minimis*, as the action was fully resolved in the original action. The filing was

not "frivolous" under 22 NYCRR §130-1.1(c) and therefore not sanctionable.

Accordingly, it is

ADJUDGED and ORDERED that the motion of plaintiffs Madison Realty Capital and 67500 South Main Street Richmond LLC to confirm the award is GRANTED; and it is further

ADJUDGED and ORDERED that the motion of defendants Scarborough-St. James Corporation and MCANY of Richmond Fund II Limited Partnership to vacate or modify the arbitration award is denied; and it is further

ADJUDGED and ORDERED that Scarborough and MCANY's II petition in the 2014 Action is denied; and it is further

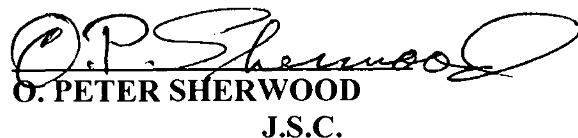
ORDERED that Madison and 67500's cross-motion for sanctions is denied; and it is further

ORDERED that Madison settle order confirming the Final Award on five (5) days notice.

This constitutes the decision and order of the court.

DATED: August 4, 2014

E N T E R,



O. PETER SHERWOOD
J.S.C.