Portfolio Media. Inc. | 860 Broadway, 6th Floor | New York, NY 10003 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Don't Underestimate The Scope Of A Bad Boy Guaranty

Law360, New York (November 27, 2012, 3:12 PM ET) -- Benjamin Franklin once famously said, "Nothing is certain in life except death and taxes." If Franklin were alive today, that quote would have to be amended slightly. In modern commercial real estate finance transactions, one thing is certain — there is no such thing as a fully nonrecourse loan.

In the bygone days of pure nonrecourse financing, if a borrower was unable or failed to perform its obligations under the mortgage loan documents, lenders would look solely to the underlying collateral for the recovery of the debt. In that scenario, lenders were essentially out of luck if the value of the collateral fell to a level below the outstanding balance of the mortgage debt. To add insult to injury, many lenders quickly learned that this lack of personal liability enabled, and in some instances encouraged, distressed borrowers to covertly siphon cash out of the property in the months leading up to a default.

Enter the bad boy guaranty. These limited guaranties were initially intended to keep borrowers and their principals honest. If a borrower committed certain bad acts, such as misappropriating funds, then the borrower and the guarantors (who were typically key principals of the borrower) would be liable to the lender for the actual loss suffered as a result of such acts.

In cases where the bad act was particularly egregious — such as filing a voluntary bankruptcy action or interfering with the lender's foreclosure action — the loan would become fully recourse to the borrower and the guarantors. These guarantees were specifically intended to prevent the principals of the borrower from diluting the value of the collateral or performing certain actions in derogation of the lender's enforcement rights.

Today, the bad boy guaranty is ubiquitous in modern commercial mortgage financing transactions, but the actual carve-out provisions themselves tend to vary from lender to lender. What was once a relatively straightforward list of limited bad acts has, in some cases, expanded into dozens of complex provisions designed to cover every conceivable instance where a borrower could possibly go astray. For this reason, it is prudent for borrowers to understand the scope of its lender's proposed bad boy guaranty before signing the term sheet or loan commitment.

Each of the bad acts (and their corresponding level of liability) should be carefully scrutinized at the outset of negotiations to ensure that the borrower and guarantors are aware of the potential liability arising out of their actions or inactions. Accordingly, the following discussion is intended to provide basic guidance in negotiating nonrecourse carve-out provisions in real estate loan transactions.

Many real estate loan term sheets and loan commitments simply refer to the lender's "standard recourse carve-out provisions," while failing to delineate the particular events or actions that can trigger personal liability in an otherwise non-recourse loan transaction. In those cases, it's prudent for borrowers to request that lenders specify the exact terms of the recourse carve-out provisions in the term sheet or loan commitment so that the guarantors can make an informed decision at the outset of negotiations, and before any loan deposits are made.

In many cases, a lender will, if asked, provide a copy of its standard bad boy guaranty for a borrower's review during the term sheet or commitment phase. The terms of the bad boy guaranty can be negotiated at that juncture, well in advance of the frenzied push toward closing, which allows the parties to concentrate on getting the deal done.

In addition to the actual carve-out events themselves, it is important to have a clear understanding of the events which will trigger limited or full liability under the loan. Take, for instance, the concept of "waste." A typical bad boy guaranty will include a provision making the guarantor liable for the lender's actual loss incurred as a result of the borrower's commission of waste at the property.

This sounds simple enough, right? But what exactly constitutes "waste?" It could mean the failure to pay real estate taxes.[1] Should it be limited to "physical waste" or, better yet, "intentional physical waste?" What about this scenario? If a borrower loses a tenant and there is a cash flow shortage for a period of time, should a borrower who uses its remaining cash flow to pay the current installment of real estate taxes as opposed to servicing the HVAC system be liable to the lender for the cost of replacing it if it stops working. The borrower will argue that it did not intentionally cause the damage to the HVAC system — it simply did not have sufficient funds to make the repairs at that time. But it's a completely different story if the borrower made distributions to its principals instead of repairing the HVAC system. A carefully negotiated bad boy guaranty will address this distinction.

In recent years, many bad boy guaranties have begun to provide that a breach of the borrower's single purpose entity (SPE) covenants constitutes a full recourse event.[2] While there may be some justification for such a position when the breach is egregious — such as the consummation of prohibited mergers and consolidations — there are many instances where technical violations of these covenants are so minor that a reasonably prudent borrower or guarantor would not expect to become fully liable for the debt as a result. One such example is a borrower failing to maintain separate letterhead.

It's important for lenders and borrowers alike to not lose sight of the real purpose of bad boy guaranties. These guaranties are supposed to level the playing field by providing lenders with a measure of protection against bad borrowers. What they're not supposed to do is turn a nonrecourse loan into a recourse loan, except in very limited circumstances.

While there have been numerous challenges to the validity of these types of guaranties, courts generally have been unwilling to alter the plain meaning of the documents, and have enforced their provisions over objections of public policy concerns and claims of unenforceable penalties — particularly where the parties involved are sophisticated investors.[3] So it clearly behooves bad boy guarantors to review the actual provisions of the bad boy guaranty with legal counsel at the outset of the loan transaction in order to avoid misunderstandings later on.

--By John C. St. Jeanos and Nicholas P. Melillo, Herrick Feinstein LLP

John St. Jeanos is a partner and Nicholas Melillo is an associate in the real estate department of Herrick Feinstein LLP. Both are based in the firm's New York office.

[1] See, e.g., Travelers Insurance Company v. 633 Third Associates, Tower 41 Associates, Joseph T. Comras, Stanley Stahl, Robert Travelers Insurance Company v. 633 Third Associates, Tower 41 Associates, Joseph T. Comras, Stanley Stahl, Robert Carmel and Citibank, N.A., as Trustee of Citibank, N.A. Commingled Employee Benefit Trust, 14 F. 3rd 114 (2nd Cir. 1994). The court held that the borrower's willful failure to pay real estate taxes constituted actionable waste, thereby triggering recourse under the bad boy guaranty.

[2] See, e.g., Wells Fargo Bank NA v. Cherryland Mall Ltd Partnership, 812 N.W.2d 799 (Mich. Ct. App. 2011). In the Cherryland case, the court construed the lengthy and complex SPE and separateness provisions to mean that the mere insolvency of the borrower triggered full recourse to the guarantor, even though there was no bankruptcy filing. The guarantor did not collude in or otherwise cause a bankruptcy, but the court was guided by the plain meaning of the provision. The full recourse result was, therefore, an unintended consequence, as the guarantor did not expect to assume general responsibility for the solvency of the borrower. Recognizing the danger posed by this decision, the Michigan legislature essentially overturned it through the passage of the Michigan Nonrecourse Mortgage Loan Act on March 29, 2012.

[3] See, e.g., UBS Commercial Mortgage Trust 2007-FL1 v. Garrison Special Opportunities Fund L.P., 938 N.Y.S.2d 230 (N.Y. Sup. 2011) and Bank of America NA v. Lightstone Holdings LLC, 938 N.Y.S.2d 225 (N.Y. Sup. 2011). In these cases, the guarantors argued that the guarantees were unenforceable because, inter alia, it is against public policy to essentially prevent a borrower from filing for bankruptcy, and impeded financial restructuring. The courts rejected these arguments, holding that there is no public policy that allows borrowers and guarantors to avoid their contractual obligations and that the courts are not in a position to re-write the terms of the contracts.