Given some recent court decisions strictly enforcing bad boy guaranties and related legislative enactments and proposals, borrowers and their sponsors who assume personal liability under these guaranties are well advised to carefully scrutinize and to try to negotiate non-recourse carve-out provisions contained in their real estate transaction documents. This article analyzes several recent court decisions and legislative actions and suggests useful strategies that borrowers and guarantors might consider to shield themselves from consequences that may result from involvement with the “bad boys.”

Typically, a commercial real estate loan is non-recourse to the borrower (and its principals) unless the borrower engages in wrongful or intentional behavior that jeopardizes the lender's collateral. Such acts include waste, fraud, misappropriation of funds, environmental abuse, and perhaps most notably, filing voluntary bankruptcy petitions or colluding with others to have such petitions filed. Lenders often obtain added protection against such bad behavior by requiring that a related “deep-pocket,” usually a principal of the borrower, execute a separate guaranty (commonly referred to as a “bad boy guaranty”), which customarily provides that if the borrower engages in prohibited behaviors, the guarantor immediately becomes liable for either the full amount of the lender's losses or, under certain circumstances like voluntary bankruptcy, for the entire loan amount.

In the past, guarantors often executed these guaranties without negotiating them heavily. The real estate market was prosperous; loans were repaid without incident and bad boy guaranties were largely considered a necessary part of the process. These guaranties were rarely triggered, much less litigated, and many borrowers assumed that lenders would resist modifying their form of guaranty, and so signed the agreement, indicating their willingness to assume what many may have considered a negligible risk in order to consummate transactions.

In light of court decisions overwhelmingly upholding the provisions of such guaranties, together with the continued downturn of the economy generally and the real estate market in particular, however, borrowers and their sponsors must carefully evaluate the range of risks contained in the guaranties prior to execution and continuously throughout the terms of their loans.

‘In Re Extended Stay’

In 2007, prior to the recent economic recession, Lightstone Holdings and its sole managing member, David Lichtenstein, purchased the Extended Stay hotel chain (ESH) for approximately $8 billion, slightly less than $2 billion of which was funded through third-party mezzanine loans, secured by membership interests in the borrower, ESH. As further security for these loans, Lightstone and Lichtenstein delivered bad boy guaranties to the mezzanine lenders, providing, among other things, that if ESH filed voluntary bankruptcy, the mezzanine loans would become recourse to the guarantors, up to $100 million. Over the next two years, amidst a global financial crisis, the hotel chain suffered and, after exhausting other available options, the borrower filed voluntary bankruptcy, triggering Lightstone’s and Lichtenstein’s personal liability under the bad boy guaranty.

In an attempt to invalidate the guaranty in court, Lichtenstein argued that his fiduciary duty to preserve company assets could only be accomplished by filing bankruptcy; otherwise he would be committing waste, which, ironically, would also have triggered liability under the guaranty. Lichtenstein further argued, unsuccessfully, that he had attempted to tender the collateral necessary to satisfy the requirements of the loan by offering lenders the deed or an assignment in lieu of foreclosure, but the lenders, unable...
to agree as to who was entitled to the collateral, refused to accept such tender. The court rejected these arguments and all others raised by Lichtenstein and upheld the guaranty, holding ultimately that the lenders had no obligation to accept such tender as a remedy.1

What should smart borrowers do? Lichtenstein’s arguments, though unsuccessful, illustrate a lesson that can benefit both lenders and borrowers when drafting or negotiating bad boy guaranties. Lenders insist on voluntary bankruptcy as a trigger in order to discourage borrowers from triggering the automatic stay imposed in connection with the filing, which prevents lenders from quickly realizing on their collateral.

While using bankruptcy as a trigger to the bad boy guaranty has been an effective tool for lenders in preventing borrower misbehavior, it also discourages bankruptcy filings when bankruptcy would be most beneficial for all parties. Although it may be difficult for borrowers to persuade lenders to permit a bankruptcy filing under any circumstances, even if such a filing is the most practical path to the company’s ultimate recovery, or if outside counsel has advised the guarantor’s or borrower’s directors that filing bankruptcy is required in order to comply with their fiduciary obligations, borrowers might consider requesting a protective provision allowing for voluntary bankruptcy in circumstances where bankruptcy is necessary in order to avoid waste of the collateral. An example of such a circumstance would be a case where, like in the Lightstone case, the borrower makes a good faith effort to tender title and/or membership interests in lieu of foreclosure, but such tender could not be effectuated due to disputes among the creditors.

‘4 Princeton Park’

The case of 4 Princeton Park Corporate Center v. SB Rental F serves as a warning to borrowers and guarantors that courts may strictly construe bad boy guaranties, even absent any evident negative impact to the lenders. In this case, encumbering the collateral property with subordinate financing without the lender’s consent was a triggering event under the guaranty. During the term of the loan, borrowers granted a second mortgage on the property without first obtaining lender consent. They timely repaid the subordinate financing, but subsequently lost their sole tenant (and rental income stream) and defaulted on the primary loan. The primary lenders foreclosed on the property and sought the deficiency amount from the guarantors, claiming that the guaranty was triggered when the subordinate financing was obtained without consent.

Bad boy guaranties should be scrutinized prior to execution, but should also be reviewed throughout the term of the loan to ensure that future acts and decisions do not inadvertently trigger liability.

The trial court granted the lenders summary judgment and the appellate court upheld the trial court’s decision, rejecting the guarantor’s argument that the subordinate financing had been fully satisfied over a year prior and that the primary lenders were not harmed by the intermittent encumbrance. The court ruled that the language of the guaranty was unambiguous, and refused to look beyond the four corners of the document, holding that sophisticated parties dealing at arm’s length had agreed upon carefully crafted terms that governed the triggering events.

What should smart borrowers do? Bad boy guaranties should be scrutinized prior to execution, but should also be reviewed throughout the term of the loan to ensure that future acts and decisions do not inadvertently trigger liability. This fact, though seemingly obvious, is worth emphasizing because in 4 Princeton Park, the borrower forgot about the guaranty trigger and did not contest the foreclosure proceeding brought by the primary lender. Given the greater time and expense a contested foreclosure takes compared to an uncontested one, guarantors may have negotiated with lenders a speedier recovery, but conditioned their cooperation in an uncontested foreclosure on lenders’ agreement to release them from liability under the guaranty. Bad boy guaranties also often contain trigger events that include “non-interference” clauses, providing that borrower interference with lender’s efforts to foreclose on its collateral triggers the guarantor’s liability. If such language is inevitable, borrowers should try to ensure that such non-interference triggers are limited to bad faith interference.

Avoid the Sand Trap

Due to the requirements of capital markets, many commercial real estate loan transactions require that the borrower is a single purpose entity (SPE) and holds the loan collateral as its sole asset(s). Lenders and investors favor this model because it isolates the SPE’s assets in the event that the borrower’s corporate affiliates file bankruptcy, hopefully preventing the lender’s collateral from becoming part of a larger debtor’s estate, minimizing the consolidation risk. Because lenders generally prefer to avoid the time and expense of bankruptcy, to discourage the SPE itself filing bankruptcy, the mortgage lender will insist that voluntary bankruptcy (as well as collusion with any involuntary bankruptcy petition) trigger liability under a bad boy guaranty.

When a mezzanine lender takes a pledged security interest in equity of the borrower, there is a hidden risk to both borrowers and guarantors. In the event the mezzanine lender forecloses on the membership interests of the borrower, such lender could subsequently force the borrower into voluntary bankruptcy, triggering the bad boy guaranty. In such case, the guarantor would have no control over the involuntary bankruptcy filing, but would nevertheless be liable under the guaranty.

To protect itself in these instances, guarantors should consider the following options:

(a) suggest language requiring the mortgage lender to accept a reasonable replacement guarantor in the event the borrower is no longer in control due to a mezzanine lender foreclosure;

(b) agree with the mezzanine lender that such lender will indemnify guarantor in the event such lender forecloses and subsequently triggers the guaranty liability, including by filing voluntary bankruptcy.
thereby discouraging the mezzanine lender from bad actions; or

(c) propose that if a majority of lenders (in a group) requests or consents to the borrower’s bankruptcy filing, then the guarantor will be exculpated from liability under the guaranty agreement.

Other Strategies

If the bad boy guaranty is triggered, depending on the terms of the guaranty and the amount of leverage the borrower has, the guarantor’s liability may range from the amount of loss or damage incurred by the lender to the full amount owed to such lender under the loan. As was illustrated in the case involving Extended Stay, one way to limit risk is to cap the guaranty obligation. In Extended Stay, the mezzanine loans totaled $1.8 billion, but the guaranty obligation was capped at $100 million. Borrowers with negotiating power in large transactions should limit their own liability to whatever extent possible.

Borrowers and guarantors with leverage to negotiate such limitations could also insist that the guaranties expire or burn down after a certain time or under certain conditions, such as the borrower no longer being in control of the underlying asset.

Another fundamental but important strategy for guarantors to consider is seeking co-guarantors, thereby spreading the risk and liability among multiple parties. In a multi-guarantor scenario, if the guaranty is triggered (by one or more parties); the liability is generally joint amongst all of the guarantors.

Hope for the Future

There is also evidence suggesting that certain state legislators are interested in assisting guarantors that have been subjected to liability under bad boy guaranties. Two recent decisions in the Michigan courts found that guaranties were triggered and that the guarantors were liable after the respective borrowers failed to make payments on the mortgage loan, and were deemed insolvent.

The Michigan legislature responded by enacting the Nonrecourse Mortgage Loan Act on March 29, 2012, which limits the potential scope of these guaranties by prohibiting any trigger based on a “post-closing solvency covenant,” which is defined as “any provision of the loan documents for a nonrecourse loan...that relates to the solvency of the borrower....” The bill does not go so far as to permit borrowers to file a voluntary bankruptcy or collude in an involuntary proceeding if prohibited by the guaranty; however, it does relate back to any loan entered into on or after the effective date of the act. It remains to be seen what impact the Michigan legislation will eventually have on nonrecourse guaranties, because in many instances such guaranties are triggered by a breach of the SPE covenants, which often include a covenant that the SPE will remain solvent.

Additional comfort, however, can be found in a recent California appellate decision denying the liability of a guarantor. GECCMC 2005-C1 Plummer Street Office v. NRFC NNN Holdings, involved a guaranty that was triggered upon “termination” of the lease of the sole tenant of the property. The tenant stopped paying rent and abandoned the property, and while the court agreed that this was a breach of the lease, a breach was not a termination under the specific language of the lease and the court held that the guaranty should therefore not be triggered. The court seemed inclined to bring the focus back onto bad actions of the borrower, finding that the parties’ intent in entering the guaranty was to protect the lender from specific bad acts of the borrower rather than acts outside of the control of the contracting parties, and reminding the parties that in the absence of such misconduct, the sole security for the loan is the property.

While neither the California decision nor the Michigan legislation indicates a reversal of the trend of courts upholding any guaranty negotiated in good faith by sophisticated parties, they do suggest that legislators may be willing to nominally protect borrowers, and also that courts will closely analyze and follow well-drafted terms and protect guarantors when appropriate.

Conclusion

The commercial real estate market is currently encumbered by billions of dollars in distressed debt. Mortgage lenders are frequently looking for some means to trigger bad boy guaranties for satisfaction (in whole or in part) of their loans. While bad boy guaranties may be an inevitable fact of life in the real estate markets, borrowers and sponsors must strategically negotiate in order to protect themselves from hidden as well as obvious risks.

References


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