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Staying Off the Hook – Managing the Evolving Bad-Boy Guaranty

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As the financial crisis of 2008 drifts further into the rear-view mirror, the cost of capital available for commercial real estate financing is historically low and accessible, frequently coming in the "non-recourse" variety and without the requirement of personal guaranties by the key principals of borrowers and their sponsors. In a perfect world, non-recourse loans limit the liability for the loan to the real property collateral securing the loan, shielding the principal's personal assets from liability. There are considerations, however, that borrowers and their legal counsel must take into account to make sure that the non-recourse loans they've entered into stay that way.

In almost every non-recourse loan situation, lenders require a "carve-out guaranty", more colloquially referred to as a "bad-boy guaranty", from the principals. These bad-boy guaranties list certain acts and occurrences that would cause the principals to be liable for either the actual losses incurred by the lender due to such acts and occurrences (commonly called "above-the-line" events) or, in the event of certain acts and occurrences, the full amount of the loan ("below-the-line" events). As non-recourse loans have developed, lenders, seeking to protect themselves in ways they hadn't prior to the last real estate crash, have steadily expanded the list of acts that can trigger increased recourse liability. Borrowers, their principals and executives, and their legal counsel should be acutely aware of which carve-outs are contained in the bad-boy guaranties, and whether they are of the above-the-line or below-the-line variety.

Initially limited to bad acts by borrowers and their key principals and executives, such as fraud, waste, commission of criminal acts, gross negligence and misappropriation, bad-boy guaranties now often contain questionable carve-outs for broader sets of acts and occurrences, including failure to maintain insurance and pay real estate property taxes, failure to deliver final statements and reports, certain transfers of the property or ownership interests in the borrowing entities, or termination of leases by tenants. In addition to lenders themselves, in the rare instances where litigation involving bad-boy guaranties even makes it to trial, courts have taken a fairly strict approach to bad-boy guaranties, more often than not strictly enforcing their terms and deferring to the judgment of the parties who negotiated and entered into the guaranties.

Fortunately for borrowers, the expansion of bad-boy guaranties has also come with an expansion of the lenders' willingness to negotiate such documents. When bad-boy guaranties consisted of standard boilerplate language and contained relatively few carve-outs, and all consisted of true bad-acts such as fraud and misappropriation of funds, borrowers and their legal counsel were left with little bargaining power – trying to convince a lender to take a soft approach, or negotiate a cure-period for instances of fraud, for instance, would have gotten you (and still will) laughed off of a conference call. The current favorable lending environment gives borrowers and their counsel additional leverage to open negotiations on loan documents that in tighter lending climates are off limits for discussion.

Borrowers and their counsel should seek to limit carve-outs to acts solely within the control of the borrower and their principals, and not of acts by third parties. One of the actions commonly found in current bad-boy guaranties that would trigger recourse liability is the commencement of involuntary bankruptcy proceedings against the borrower. These involuntary proceedings are outside of the control of borrowers, and borrowers should request to have these events removed from the listing of carve-outs. At a minimum, borrowers and their counsel should attempt to specifically limit these carve-outs to involuntary proceedings which borrowers have consented to, acquiesced in or orchestrated, bringing the carve-outs back within the realm of their control.

Another common, and usually negotiable, carve-out contained in current bad-boy guaranties imposes recourse liability when the borrower fails to pay real estate taxes on the property. While non-payments is certainly a troubling occurrence for borrowers and lenders alike, borrowers should seek to limit recourse to the amount of the lender's actual losses and only to instances of willful non-payment, and not of instances where insufficient income from the property is the cause of the failure to pay. This change transforms the carve-out from something that could be triggered by a poorly performing property (which is inherent in the risk taken by the lender making the loan and factored into the pricing of the loan), to one truly caused by an action, or in this case, inaction, of the borrower, and more in line with the spirit of a bad-boy guaranty.

Lenders should not use bad-boy guaranties as a repository for all events of default under the loan. Borrowers should carefully read bad-boy guaranties to ensure that events that are typically defaults, but not the variety to be included in bad-boy guaranties, are not included in the agreement. Some common examples of acts found in bad-boy guaranties that wrongfully trigger recourse liability include: failure to meet financial reporting deadlines, failure of the borrower to stay solvent, any transfers of the property or ownership interests of the borrower, failure of the borrower to allow lender and their agents to inspect the property, and the recordation of any liens or encumbrances against the property. While these all have their place in the loan documents, and are ripe for negotiation by both the business and legal representatives of borrowers and lenders, they shouldn't be included in bad-boy guaranties.

The expansion of lenders' willingness to make funds available for commercial real estate financings creates great opportunities for new acquisitions, development and refinancings, but borrowers, their principals and their legal counsel shouldn't let their guard down because the loan is of the non-recourse variety. A standard bad-boy guaranty signed ten years ago looked significantly different than a standard bad-boy guaranty today, and borrowers should take all of the necessary steps to understand the scope of their liability, and work with lenders to limit that scope to apply only to true bad-acts within the control of those signing the document.

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