THE MORTGAGE OBSERVER

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Stein's Law

Better Luck Next Time

When the refinancing closed, the real estate investor—the principal of the borrower—leaned over to his counsel and asked just two questions. The first related to the interest rate on the loan. The second question, the only other thing the investor really cared about was, "Show me the personal guaranty. And can you promise me I'm not signing on for anything I didn't agree to guarantee?"

It was a bedrock proposition that guaranties wouldn't cover the entire loan, just particular deal-specific risks and a typical list of "standard nonrecourse carveouts."

Recent cases have, however, thrown curve balls to guarantors of "standard nonrecourse carveouts." Courts have found them liable for the entire loan under circumstances that never should have triggered such liability.

First off, start with the principles that drive nonrecourse guaranties. They are supposed to discourage borrowers from doing bad things. But then ask what might happen if a property starts to get into trouble. What are the ordinary consequences of financial distress for commercial real estate? Those aren't "bad

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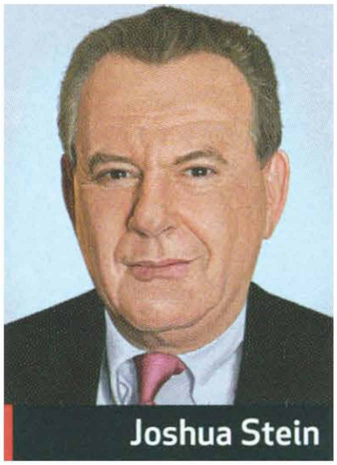
things" a borrower might do—they are just the consequences of financial distress. They shouldn't trigger liability for the guarantor.

Therefore, parse through events that might trigger personal liability for the entire loan.


Joshua Stein

If any language in a carveout guaranty could be construed to trigger personal liability under such circumstances, the guarantor and their counsel need to get rid of it. Otherwise, the "carveout guaranty" amounts to an unintended full guaranty of the loan, because that's what it will become at the only time that matters, i.e. when the property gets into trouble and the loan heads toward default.

Guarantors and their counsel also need to focus on two areas that don't always tie to the property's financial performance: intertwined defined terms and obligations that prohibit transfers and require the borrower to remain "separate" or a "single-purpose entity." These concepts have accreted over time, with the result that they now impose on a borrower a list of obligations both great and small. Some trivial violation of one of those obligations shouldn't make a guarantor liable for the entire loan.

For example, the loan documents might require the borrower to remain a "single-purpose entity." The loan documents might also say that a "single-purpose entity" must have a separate telephone number. If the borrower shares a telephone number with a related company, then this might trigger a claim that it's not a "single-purpose entity," thus making the guarantor liable for the entire loan.

A guarantor and their counsel might respond by saying that the guarantor shouldn't face liability because of such

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issues unless those issues actually result in the problem that they were designed to prevent. Specifically, the guarantor would become liable for the loan only if these issues caused the borrower to become "substantively consolidated" with another entity in a bankruptcy proceeding. Unless that happens, the lender doesn't really suffer any loss. Some sloppiness in this area might marginally increase the lender's risks in a possible future bankruptcy—but that by itself shouldn't trigger personal liability for the entire loan.

A guarantor also should insist on having a chance to repair any problem that might otherwise trigger personal liability. For example, if the lender were concerned about the borrower's shared telephone number, the lender should first give the guarantor a chance to solve the lender's concern.

Guarantors and their counsel might also note that the whole theory of a nonrecourse loan contemplates that a borrower can "walk away" from the collateral and let the lender keep it. But the law generally does not allow a borrower to give the lender the keys unless the lender agrees to accept them. So even if a borrower wants to roll over and let the lender have the collateral and cut off any further potential exposure and issues for the guarantor, they can't.

Tomorrow's guarantors may say that, no matter what, their liability should stop accruing if the borrower offers the lender a deed to the collateral or functionally equivalent control of the collateral. This wouldn't necessarily terminate any guarantor liability that already existed, but it would give borrower and guarantor an easy exit, consistent with the underlying theory of nonrecourse loans. Without it borrowers don't have a right to walk away, which was the whole point.

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