THE MORTGAGE OBSERVER
April 2012 - Page 28



# Guaranties Bite

BY JOSHUA STEIN

It's only a nonrecourse carveout guaranty—nothing to worry about, right? Well just don't file bankruptcy, mess around with the collateral or get up to other mischief. It's still a nonrecourse loan.

That was the mantra for thousands of commercial real estate loans that closed in the boom years. And everyone believed it—until recently, when some nonrecourse carveout guaranties started blowing up in the faces of guarantors, in ways that no one ever envisioned.

Opportunitistic loan purchasers have scrutinized the fine print of the nonrecourse carveouts. Using that fine print and interpretations that were never anticipated, the loan purchasers are demanding that "carveout guarantors" pay the entire loan under circumstances that no one ever thought would trigger such liability.

In one Michigan case, *Cherryland Mall*, the loan documents required the guarantor to pay the entire loan out of its personal assets if the borrower didn't remain a "single purpose entity." One of the single purpose entity covenants (covering ground that would typically fall under a different provision of the loan documents) required the borrower to stay "solvent." The collateral value dropped below the loan balance, the loan went into default, and—*bingo!*—the loan holder successfully claimed that the borrower was insolvent, so the guarantor faced liability for the entire loan.

The documents in another Michigan case, *Chesterfield*, produced a similar surprise. Here, the guarantor had to pay the loan if the borrower didn't comply with "separateness covenants." One required the borrower to pay its debts from its own assets. When the borrower stopped paying the loan, the lender claimed the guarantor became personally liable for the entire loan. The court agreed.

These two cases have shocked the commercial real estate lending community, by making a guarantor liable for the whole loan at exactly the point—loan default—where nonrecourse treatment matters most. Any nonrecourse loan fundamentally contemplates that if a property gets into trouble, the borrower can walk away without liability. The borrower and its principals are not supposed to place their "other assets" at risk if the collateral can't support the loan. The borrower has choices very much like dealing with a pawn shop, at a different stratum of the credit market.

The two Michigan cases may represent the beginning of a trend, though, where opportunistic loan purchasers scrutinize a nonrecourse carveout guaranty, and assert claims against guarantors in ways that no one ever expected.

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In other cases, innocent or trivial actions by borrowers have been asserted as the basis for triggering claims under nonrecourse carveout guaranties. We can expect to see more of this.

In one case, a limited liability company borrower wasn't supposed to change its business purpose—but someone foolishly and probably innocently amended the organizational papers to broaden the company's permitted activities. This, again, violated the single-purpose entity covenants and—again, *bingo!*—the lender claimed the guarantor had to pay the entire loan.

Mortgage/mezzanine financing structures offer fertile ground for these claims. In one case, the mortgage lender foreclosed. The mezzanine lender said this was a prohibited transfer, triggering the nonrecourse carveout guaranty for the mezzanine loan. The court ultimately didn't buy it, but the guarantor spent many months in litigation to get there.

The converse situation could also produce surprises: a mezzanine lender forecloses, takes control of the mortgage borrower, and throws it into bankruptcy. Next thing you know the mortgage lender can sue the carveout guarantor for the entire loan, because the mortgage borrower filed bankruptcy.

In a pending case, the lender is claiming the guarantor must repay the entire loan because the borrower incurred levels of indebtedness—in this case, ordinary unpaid trade payables—that violated the loan documents, and didn't remove some mechanics' liens.

In all these cases, everyone expected that the ordinary vicissitudes of commercial real estate were part of the lender's risk—not the guarantor's risk—when the parties negotiated their loans. But aggressive loan purchasers have sometimes been able to interpret loan documents in a way that no one would have anticipated, and in fact in a way entirely inconsistent with the underlying theory and deal structure of nonrecourse financing. We are probably not done with surprises in this area.

Regardless of how today's litigations turn out, tomorrow's loan negotiators now know about one more problem area on which to focus. And deal sponsors may "just say no" when asked to sign nonrecourse carveout guaranties. The risk of surprises is just too great.

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