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Non-Recourse Guaranties – Has The Pendulum Swung Too Far?

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Non-Recourse Guaranties – Has The Pendulum Swung Too Far?

In connection with the development or acquisition of senior health care related real estate, the principals of a corporate borrower are frequently asked to enter into a non-recourse carve-out guaranty agreement. Frequently, that request is contained in a commitment letter delivered to the borrower at the commencement of the transaction. Many principals who have not signed such an agreement in the last few years are surprised by the content of that guarantee agreement when it is finally presented to them, as it has moved from being a fairly short, concise document establishing liability in very limited circumstances to a broadly drawn instrument that imposes liability under an increasingly wide variety of circumstances that have not historically generated liability for guarantors. That metamorphosis began following the 2008 financial crisis when the two largest guarantors of mortgage paper, FNMA and FHLMC were put in conservatorship. With this action, the governance of these two entities began to consider all points of all documents related to new loan originations. In most cases, significant changes were made obligating the borrowing entities and their key principals to a significantly higher degree of accountability. In many cases the changes made to these agency documents have "spilled over" to other lending institutions creating far more detailed provisions for those documents, including waivers and disclaimers, have prevented courts from granting relief to guarantors and are now strictly enforced. In the event that a borrower is unable to negotiate away the obligation to provide a non-recourse carve-out guarantee, the guarantors should understand exactly the type of liabilities they may be asked to accept.

Much real estate finance is taken out on a non-recourse basis, meaning that the lender has recourse only to the real estate assets in order to recover the amounts lent to the borrower. In such structures, there is generally no recourse to either the borrower or any other person. Non-recourse carve-out guaranties were requested by lenders as an exception to that non-recourse structure in order to provide them with recourse to the assets of certain persons in addition to the collateral where certain prohibited events (or "bad boy" acts) had occurred. The theory underlying the request for such a guaranty was that the lenders wanted a specified warm body individual with some influence over the borrower to act as a policeman with respect to the project who would:

(i) prevent the occurrence of certain "bad boy" acts within the control of the guarantor or borrower that might adversely affect the collateral; and

(ii) insure that the lender's path to foreclose on the collateral was not impeded by the occurrence of legal actions such as bankruptcy filings or other protective measures that could be taken by the borrower.

When non-recourse guaranties were first introduced, the guarantors were liable for only a limited number of events that were caused by the borrower or some other person controlled by that guarantor. The original list usually encompassed:

> fraud;
> misapplication of proceeds from casualty or condemnation events;
> waste of the assets; and
> environmental liabilities.

The prevailing thought was that by making the guarantor liable for these material events, the guarantor would take every measure to insure that such events did not occur. Given the relatively rare incidence of the triggering events and the fact that the event had to be caused by a person within the guarantor's control, guarantors could usually be comfortable that, by exercising reasonable oversight, they would not incur liability under the non-recourse guaranty.

Since the assets securing the loan were to be the sole source for recovery, lenders wanted to assure themselves that there would be no impediment to getting at the collateral following a default. Generally, the borrowers under such non-recourse structures were single purpose entities that had no other assets. Over time, lenders became concerned as a result of cases in which borrowers and their principals forced the borrower into bankruptcy and then used the cash generated by the project to fight the lenders in court. As a result of such actions, lenders began to insist that the guarantor also agree to be liable under the non-recourse guarantee if any bankruptcy or similar action was filed by the borrower or the borrower or guarantor encouraged others to file such an action and actively participated in holding up the lender.

Even with the inclusion of the bankruptcy restrictions, guarantors could still have a high degree of confidence that they were in control of the events that would trigger liability as such events were fairly tightly defined.

Over the last ten years, there has been a marked expansion of the events that could possibly give rise to liability in favor of lenders. The liability under the non-recourse carve-out guaranty is generally divided into two types: loss liability, where the guarantor is responsible for making the lender whole for certain losses incurred by the lender as a result of triggering events; and full liability, where the guarantor becomes responsible for the entire amount of the loan.

Loss Liability

Over the course of the last 10 years, the range of events that could impose liability on the guarantor has expanded considerably. Such events now include:

- the failure to discharge mechanic's liens on the project;
- the failure to replace a property manager;
- the failure to renew insurance;
- the failure to repair the project;
- the failure to comply with leasing restrictions;
- the failure to pay real estate taxes;
- the failure to maintain security deposits in trust;
- the failure to comply with ERISA;
- the failure to indemnify the lender in accordance with the loan documents;
- the failure to pay the lender certain yield maintenance payments;
- the failure to comply with restrictions on amending leases or accepting prepayments of rent;
- the failure to apply rental income to the payment of property expenses and debt service;
- misuse of revenue from the project;
- any act of damage, arson or removal of collateral from the project;
- any impairment or contest of any lien;
- any allegation of a joint venture or partnership with a lender; and
- the occurrence of any full liability event.

Many of the foregoing do not constitute the type of bad act that the non-recourse guaranty was originally designed to prevent. In fact, some of these (such as failure to pay insurance, repair the property and discharge mechanic's liens) are both expenses that are incurred by borrowers in the ordinary course of business and expenses that the lender is generally authorized to advance and add to the loan balance in order to protect its collateral. As a result, it is questionable why such events have been included in a non-recourse guarantee at all, since the lender has a self-help remedy.

While it is possible for lenders to claim that the occurrence of these events will adversely affect the value of the collateral, there has clearly been a diminution of the materiality of the bad boy nature of the events giving rise to liability. Perhaps it is time for borrowers to refocus on the substantiality and materiality of the events that initially gave rise to liability and to attempt to push back on some of those liability triggers. In truth, some of the liabilities for which guarantors are now being made responsible are only likely to occur following a default and when the borrower is in distress. Such is clearly the case with the yield maintenance and indemnification payments listed above. It does not seem to be in keeping with the original intent of the non-recourse carve-out guarantee to make the guarantor responsible for those payments in circumstances where the borrower is unable to make the payment because of its predicament and not as a result of any bad act.

Full Loan Liability

In addition to full loan liability for filing or colluding in a bankruptcy, such liability is now imposed by lenders for the following:

> prohibited transfers of the property or borrowers;
> prohibited secondary financing;
> violation of the special purpose entity (SPE) covenants in the underlying loan agreement; and
> interfering with the lender's exercise of its remedies.

Guarantors should be aware that courts have been willing to strictly enforce the full loan liability provisions of non-recourse carve-out guaranties. In a recent case in New Jersey, the borrower incurred secondary financing that was prohibited under the loan documents and that triggered full loan liability under the non-recourse guarantee. The borrower repaid the entire amount of the secondary financing while the senior loan was still in good standing, but failed to effect the release of the mortgage securing the second lien. Eighteen months following the repayment in full of the secondary financing, the borrower defaulted. The New Jersey courts found that, even though no appreciable harm was suffered by the lender, the terms of the non-recourse guarantee were enforceable and imposed liability on the guarantor for the full amount of the loan. CSFB 2001-CP-4 Princeton Park Corp. Center, LLC v SB Rental I, LLC, 980 A.2d 1 (N.J. Super. Ct. App. Div. 2009).

Guarantors should also be mindful of the provisions relating to a prohibited transfer of the project or the borrower. Very often, such provisions can be triggered by the transfer of a fairly minimal amount of equity by direct or indirect equity holders of the borrower. Sometimes, the relevant holders can be several levels removed from the actual borrower, and it is necessary to work through in detail exactly which direct and indirect equity holders may trigger such a provision.

SPE Covenants

SPE covenants present a unique problem for non-recourse guarantors in the realm of full loan liability. Frequently, the terms of the non-recourse guarantee will be negotiated around the time that a commitment letter is signed and in advance of the negotiation of the loan agreement. The guarantor may agree to liability in the event that those provisions are violated with the expectation that the SPE covenants will be both minimal and tightly drawn. Like the non-recourse carve-out guarantee, the list of SPE covenants has expanded exponentially over the years, and it is not uncommon now for those to run to several pages. When the loan agreement is finally delivered, both counsel and guarantors often fail to negotiate the SPE provisions of the Loan Agreement with one eye on the terms of the non-recourse guarantee and without bearing in mind that any violation of those SPE provisions could lead to full loan liability. As a result, many borrowers agree to a set of SPE covenants that are much broader than would be the case if the SPE covenants were being reviewed as a potential trigger for full loan liability. What guarantor would agree to a provision requiring each member of the borrower group to use its own stationery and a separate bank account, or an obligation to correct any error in properly identifying the borrower, if the failure to comply with such provisions could trigger full loan liability?

Two recent cases also highlight how the SPE covenants can be a backdoor through which unexpected full loan liability may pass. In Wells Fargo Bank, NA v. Cherryland Mall Ltd. Partnership, 812 N.W.2d 799 (Mich. Ct. App. 2011), the guarantor executed a non-recourse guarantee under which full loan liability was triggered if the SPE covenants were violated. Among the SPE covenants agreed to by the borrower was an undertaking that the borrower would at all times remain solvent. As a result of a decline in the value of the underlying property (which was the sole collateral for the loan), the borrower was deemed insolvent. The insolvency was a breach of the SPE covenants and caused full loan liability of the guarantor under the non-recourse guaranty. This case highlights perfectly the multiple problems of (i) borrowers agreeing to SPE covenants that may have unintended consequences under the non-recourse guarantee, (ii) guarantors making themselves liable for acts and events that are out of their control, and (iii) liability under a non-recourse guarantee that is triggered without any "bad" act by either the borrower or the guarantor.

Certain states have recognized the problem caused by this lack of causation by guarantors and have enacted specific legislation to address that issue. Michigan, for example, has enacted the Nonrecourse Mortgage Loan Act (Mich. Comp. Laws §§445.1591-.1595 (2012)), which prevents the assertion of liability under a NRG where it is triggered solely by insolvency caused by a reduction in the value of the collateral.

Control of Events Causing Liability

As mentioned above, guarantors traditionally have taken comfort from the fact that they will not incur liability under the recourse carve-out guarantee unless they actually engage in a "bad" act and cause a liability triggering event to happen. Guarantors should review the terms of the guarantee carefully to make sure that is indeed the case, as many lenders have developed forms of guarantee that would impose liability upon guarantors even where they are no longer in control of the borrower. In particular, guarantors should review carefully all of the waivers and disclaimers and attempt to insert such causation language into the guarantee, otherwise they may be liable where:

(i) the guarantor no longer owns a controlling interest in the borrower as a result of transfer of equity interests, corporate restructuring, dilution or expiration of contractual controls; or

(ii) the equity interests that entitled the guarantor to a controlling interest in the borrower have been foreclosed upon by a third party, such as a mezzanine lender.

In the second of these cases in particular, guarantors should specifically negotiate for provisions under which they will not incur liability as a result of actions taken following foreclosure by another lender, such as a mezzanine lender. Such matters may be regulated among the lenders pursuant to an intercreditor agreement. They should also make sure that such a foreclosure by a mezzanine or junior lender (which results in a transfer of control of the borrower) does not, in and of itself, constitute a triggering event under a non-recourse guarantee given with respect to the senior loan.

In addition, guarantors should be aware of the exposure that they may have as a result of the existence of fiduciary duties to the shareholders of the borrower or its affiliates. While a guarantor may be motivated not to file an action seeking bankruptcy protection to avoid personally incurring full loan liability on a guarantee, that guarantor, depending on his position in the management of the borrower and its affiliates, may have a fiduciary duty to his equity holders to file such a bankruptcy action if it is in the best interests of the company. A guarantor who elects not to file such an action in order to protect his personal interests may ultimately be liable to his shareholders. In that regard, it is important for guarantors to review the agreements among the equity holders of the borrower and its affiliates in order to protect themselves from such an action and to seek permission in advance from those other equity holders to allow the guarantors to protect their interests to the detriment of the borrower. The problem becomes even more acute for guarantors whose companies may have invested in multiple sectors including the senior housing sector.

Summary

I would suspect that most lenders reading this article will have no inclination to move away from the lender-friendly provisions that they have been able to obtain from borrowers. In truth, the genie is out of the bottle, and many of these provisions have become "market." It would be difficult to get the genie back in the bottle again. It should be borne in mind, however, that what is market simply reflects what a number of lenders and borrowers are willing to accept. That changes over time, and, given that the provisions of non-recourse guarantees have moved so far in favor of lenders, perhaps it is time for guarantors to try and reverse that. Certainly, there are some provisions of these guarantees that borrowers will have a hard time changing. At a minimum, guarantors should take the time to go back to first principles with these types of guarantees and examine the following issues.

High on the priority list of issues to really examine are the SPE covenants. The Cherryland case deftly illustrates how far non-recourse guarantees have moved from the original intent of the document, which was designed to impose liability for a few truly "bad" acts caused by the guarantor or someone within the guarantor's control. In Cherryland, the guarantor did not cause or control in any way the event that led to liability, which was a material diminution in the value of the underlying collateral as a result of market forces. The risk of a decline in the value of the underlying collateral has traditionally been a risk borne by the lender. That risk has now passed to the guarantor.

Traditionally there was a direct connection between the action taken and some impediment to the creditor exercising its rights or a measurable impact on the collateral. Frequently, the breach of SPE covenants does not yield either of those results. A breach of the SPE covenants may increase the risk of certain events, but there are many ways in which the covenants can be breached that will not directly prevent a creditor from recovering or foreclosing on the collateral or that result in a reduction in the collateral available.

As a result, if guarantors cannot get SPE compliance removed from a non-recourse guarantee, they should be attempting strenuously to get the lender to agree that the guarantor should only be subject to loss liability, in other words, the liability should only be triggered for actual increased costs borne by the lender or a determinable reduction in the value of the collateral as a result of the breach of the SPE covenant.

At a minimum, unless they are covered by the Michigan legislation mentioned above, guarantors should insist upon a limitation on any liability where the SPE covenants are breached solely as a result of the diminution in the value of the underlying property. Guarantors should also insist on receiving a listing of the SPE covenants at the same time as they receive the form of guarantee in order to assure themselves that liability under the guarantee will only result from a material breach. In that regard, guarantors may wish to negotiate for liability to be triggered only if certain SPE covenants are breached, rather than any SPE covenant included in the loan agreement.

In addition to trying to limit the impact of certain of the SPE covenants, guarantors should determine whether:

> they are clearly able to control the actions for which they are to be liable;

> each event that is a trigger for liability is likely to cause a clearly identified diminution in the value of the collateral or a true restriction on the lender's ability to satisfy itself from the collateral;

> Each triggering event is the type of occurrence with respect to which a lender can exercise self-help by simply advancing funds that would be secured as part of the loan;

> each of the actions for which the guarantor is to be liable constitutes a "bad" act, rather than simply an expense with respect to which the lender has the right to advance funds and claim the same priority of security;

> there are definitions and provisions incorporated from other documents and whether the guarantor understands completely how those provisions may affect the guarantee (e.g., the definition of affiliates);

> liability may be triggered if the guarantor no longer serves as an officer, manager, director or controlling shareholder of the borrower (especially following a foreclosure on equity interests); and

> liability is triggered only if the guarantor (or a person the guarantor controls) causes the action or is triggered if another person (such as a mezzanine lender) causes the action.

Over and above the foregoing, as a general proposition, the guarantor should clearly understand all of the provisions of the guarantee. For example, certain terms that are traditionally included in non-recourse guarantees, such as “waste of the property” and “collusion with lenders in connection with an involuntary bankruptcy,” are generally vague, and it may be beneficial to add greater precision and clarity to such terms.

For lenders, there may be advantages in refocusing the content of the non-recourse guarantee. With so much at stake for guarantors and values of senior health care properties rising in an increasingly competitive market, it is often worth it for guarantors to commence litigation in order to delay the enforcement of guarantees against them or engage in other delaying tactics to avoid such enforcement.

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