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LOAN GUARANTEES

Broad Scope May Trigger Catastrophe for the Unwary


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With the exploding number of defaults of mortgages secured by commercial properties, and the attendant increase in foreclosure proceedings, there is an enhanced need for attorneys representing commercial property owners to be aware of, and understand the implications of, the nature of any guarantee or indemnification agreements that their clients may have executed with respect to mortgages on their properties. While guarantees were often glossed over by borrowers entering into commercial real estate loan agreements during the halcyon days of the early 2000s, now, with an increasing number of commercial properties worth less than the mortgages that they secure, the type of guarantee that was negotiated at the time of the loan issuance has taken on great importance and has been the focus of a great deal of recent litigation. Among other implications, the type of guarantee that was provided will dictate whether a lender may sue the guarantor for a "deficiency judgment," i.e., a judgment for the difference between the outstanding amount of the loan and the amount that is received by the lender in a foreclosure sale of the property. In anticipation of a continued trend of commercial real estate loan defaults, loan workout counsel should take a proactive approach in reviewing their clients' loan agreements and guarantees to gauge client exposure.

There is a broad spectrum of types of guarantees. On one end of the spectrum there are "non-recourse loans" without any type of personal guarantee, where the lender must look solely to the property in a foreclosure action to collect on a defaulted mortgage. On the other end of the spectrum are loans that are unequivocally personally guaranteed. Some commercial loans are "recourse," meaning that the lender can look to assets of the borrower entity in addition to the property, but are not personally guaranteed. Because most commercial property is owned by single-asset entities, lenders in such cases must still look solely to the real estate. Most contemporary mortgages on commercial property, however, fall somewhere in the middle and are properly described as "limited recourse loans." This article examines common provisions contained in such limited recourse loans that may "trigger" recourse liability to guarantors, as well as recent case law in which courts have addressed the enforceability of such conditions.


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Springing Guarantees

Springing (or "exploding") guarantees are very common today, and are used by lenders to discourage borrowers from taking actions that may be beneficial to the borrower, but either damage the lender's security or interfere with the lender's ability to exercise certain rights. Springing guarantee provisions usually contain language that allows the lender to recover the entire outstanding amount of the debt from the guarantor if the primary obligor or guarantor breaches certain delineated covenants in the loan documents. A springing guarantee is typically signed by a principal or other equity-holder of the borrower entering into the loan. The obligations of the guarantor do not "spring" into existence until the occurrence of a specific event.

Although the events that will trigger a guarantor's obligation under a springing guarantee provision vary from agreement to agreement, there are some standard triggering events that are often found in such agreements. These include:

- Fraud or misrepresentation on the part of the borrower, which could also give lender a common law cause of action to possibly rescind the loan agreement.
- Borrower's filing of a voluntary petition for bankruptcy (or failing to oppose the filing of an involuntary bankruptcy);
- Where the borrower is a single-purpose entity, the failure of the borrower to remain a single-purpose entity (i.e., engaging in business unrelated to the management, acquisition and ownership of the property);
- Borrower giving consent to a dissolution or winding up of business;
- Borrower commingling funds or assets with any other entity except as permitted by the loan documents;
- Borrower ceasing operation of its business in its name; and
- Borrower loaning money to an affiliate.

Borrowers, guarantors and their counsel should take heed of the scope of such provisions to avoid the potentially catastrophic effect of "springing" personal liability. For example, notwithstanding the commonly understood definitions of the terms "fraud" and "misrepresentation," certain loan documents, frequently seen in association with mortgages issued with the intent to be transferred to a commercial mortgage backed security pool, define "fraud and misrepresentation" to include gross negligence. That definition is not only counter-intuitive but could potentially be a trap for the unwary guarantor. Counsel should also be aware of the potential conflict between what might be best for the borrower (i.e., filing for bankruptcy) and the potential catastrophic personal consequences to borrowing management (the guarantor) of a springing guaranty.

Carve-Out Guarantees

"Carve-outs" are similar to springing guarantees in that they are usually directed at "bad acts" by the borrower to trigger recourse liability. However, unlike "springing guarantees" which may make the guarantor liable for the entirety of the loan amount, a lender's recovery under a "carve-out" is normally limited to actual damages incurred by the lender as a result of the borrower's bad act. Indeed, the term "carve-out" is designed to reflect that these provisions are exceptions to the general non-recourse nature of the loan.

Judicial Treatment

Courts have historically strictly enforced limited-recourse provisions, and thus, it is important for attorneys representing property owners and guarantors to be familiar with the nature and extent of their clients' guarantee obligations. New York attorneys representing commercial property owners and guarantors should also be aware of recent treatment of such commercial loan guarantees, both by New York courts as well as by courts in neighboring jurisdictions.

Recently, in *CSFB 2001-CP-4 Princeton Park Corporate Center, LLC v. SB Rental I, LLC*,[1] an appellate court in New Jersey upheld the enforceability of a springing guarantee in a $13,300,000 loan agreement, which was triggered when the borrower in a commercial loan transaction obtained a second mortgage on the property that secured the loan at issue. Secondary financing without lender's consent was a springing event. Particularly surprising in that case was the timing of the trigger of the springing guarantee. The objectionable second loan was obtained and fully paid off over a full year before borrower defaulted in making its mortgage payment to the lender/plaintiff. Thus, there was no nexus between the triggering event and the default that brought about the foreclosure proceeding and no perceivable damage to the lender/plaintiff as a result of the triggering event. Yet, following foreclosure and a sheriff's sale of the subject property, the lender sought, and received, a deficiency judgment for the $5,195,932.72 outstanding indebtedness due under the loan against the guarantors, ruling that subordinate financing by borrower over a year earlier had triggered full recourse.

In affirming the deficiency judgment entered by the trial court, the New Jersey Appellate Division held that the springing guarantee was neither an unenforceable penalty nor an unreasonable liquidated damages provision. In doing so, the court observed that non-recourse carve-out clauses are not considered liquidated damages provisions because: (1) they fix the terms and conditions of personal liability and not probable damages; and (2) they provide for actual damages. The court rejected the borrower's argument that lender was not damaged as a result of the subordinate financing, and noted that "[b]y further encumbering the property, even if only temporarily, defendants' action had the potential to affect the viability and value of the collateral that secured the original loan."[2] Thus, the court held that, even absent any real damage to the lender, the "potential" impact that obtaining a subordinate loan on the property might have on the value of the property was sufficient to enforce the springing guarantee provision.

Among other cases cited with approval by the *CSFB 2001-CP-4 Princeton Park Corporate Center, LLC* court is *Blue Hills Office Park LLC v. JPMorgan Chase Bank.*[3] In *Blue Hills Office Park*, the court sided with a lender in adopting a broad, and surprising, definition of the term "mortgaged property" and held that borrower had transferred a part of the mortgaged property without lender's consent which, along with other "bad acts," triggered the springing guarantee provision of the loan documents. The court pointed to the definition section in the parties' mortgage agreement which provided that "[u]nless the context clearly indicates a contrary intent or unless otherwise specifically provided herein…the words 'Mortgaged Property' shall include any portion of the Mortgaged Property and any interest therein…." The court held, under this definition, a zoning appeal that borrower commenced with respect to a proposed parking structure that would allegedly degrade the property securing the loan, and the settlement proceeds realized from the appeal, were part of the "mortgaged property." Consequently, the borrower's transfer of those funds without lender's consent triggered recourse liability for the full outstanding balance on the loan, which was in excess of $10,770,000.

Strict application of limited recourse provisions by courts, however, does not always cut against the guarantor. Additionally, one New York court in a very recent case has shown a willingness to adopt less dogmatic approach to determining whether to enforce springing guarantees against guarantors. In *ING Real Estate Finance v. Park Avenue Hotel Acquisition, LLC*, the court dismissed a claim by lenders for a deficiency judgment against guarantors with respect to a limited recourse loan. There, no doubt influenced by *CSFB 2001-CP-4 Princeton Park Corporate Center, LLC* and *Blue Hill Office Park*, lenders/plaintiffs amended their foreclosure complaint to include a cause of action against two prominent real estate developers to enforce a springing guarantee with respect to a $145,000,000 loan issued in connection with a planned hotel project. The lenders in *ING Real Estate Finance* claimed that, as a consequence of borrowers' failure to pay $278,759 in real estate taxes, the springing guarantee provision in the loan agreement was triggered and, thus, that the real estate developers were personally liable for the full $145,600,000 balance of the loan.[4]

The guarantors successfully argued in their motion to dismiss that a conflicting provision of the parties' credit agreement provided for a thirty-day cure period upon filing of a lien before recourse. The guarantors provided the court with evidence that the taxes were paid within nineteen days, well within the thirty day cure period. Thus, the guarantors argued, their liability under the springing guarantee had never "sprung." The lenders' opposing argument hinged on a conflicting provision of the credit agreement calling for full recourse immediately upon indebtedness.

Finding in favor of the guarantors, and dismissing the claim for a deficiency judgment against the guarantors, the court relied on the well established rule that "a commercial agreement should not be interpreted in a commercially unreasonable manner" and held that "[i]mmediate liability for the entire debt is not a reasonable measure of any probable loss associated with the delinquent payment of a relatively small amount of taxes."[5] "Thus, the *ING Real Estate Finance* holding signals a different philosophical approach from that of the courts in *CSFB 2001-CP-4 Princeton Park Corporate Center* and *Blue Hill Office Park* as well as other courts that have strictly enforced limited recourse provisions.

The lesson from these recent cases is that, while courts have historically strictly enforced limited recourse guarantees against guarantors, there are signs that, given the current economic climate, courts may be open to entertaining a more pragmatic and equitable approach to interpreting and applying guarantee provisions than they historically have been. Thus, counsel faced with defending a claim that their client has triggered liability under such a guarantee provision should always carefully analyze the relevant loan documents for conflicting provisions, which may provide a viable defense to claims for guarantor liability. Ultimately, it has never been more important that attorneys be equipped to counsel their clients how not to trigger such catastrophic liability in the first place. Thus, attorneys must familiarize themselves with any guarantee provision affecting their clients at the earliest possible point in the litigation.

1. 410 N.J.Super. 114, 980 A.2d 1 (N.J. Super. A.D. 2009).
2. 410 N.J. Super. 114, 124, A.2d 1, 7.
3. 477 F. Supp. 2d 366 (D. Mass. 2007)
4. 2010 WL 653972 (Sup. Ct. New York Co. 2010).
5. 2010 WL 653972 (Sup. Ct. New York Co. 2010).