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Real Estate Workout Advisory

December 28, 2009

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Bad Boy Guaranty Update — Lenders On A Winning Streak

by Mark S. Edelstein

For many years, one of the holy grails for real estate lenders has been to find a structure that will render borrowers "bankruptcy proof." But like squaring the circle, lenders should understand that under the American system of jurisprudence, there is no such thing as a bankruptcy proof entity, at least as it relates to a typical entity which owns and operates commercial real estate. The lending community was most recently reminded of this fact in the ongoing General Growth Properties ("GGP") bankruptcy case, where GGP found ways to file hundreds of its property-owning subsidiaries, notwithstanding "bankruptcy remote" structures intended to impede such bankruptcy filings, and successfully defended the efficacy of those filings from legal challenge by various lenders. Extended Stay Hotels ("ESH") also found its way into bankruptcy despite efforts by its lenders to structure its loans to ESH to avoid that outcome. GGP and ESH remind the real estate community that "bankruptcy remote" does not equate to "bankruptcy proof."

"Bankruptcy remote" structuring describes methods used by lenders to make the bankruptcy of a borrower as unlikely to occur—or as remote—as possible. Bankruptcy remote structuring will continue, but no doubt in the aftermath of GGP, ESH and other cases before the courts, the methods will be fine-tuned or altered to reflect the new guidance from the bankruptcy bench.

Bankruptcy remote structuring usually embraces special purpose entities (SPEs) which restrict the activities of the borrower to a single purpose, namely owning and operating the asset or assets being financed. By limiting the likelihood that the borrower will have other creditors and including limitations in the borrower's organizational documents so that creditors know other activities and debt are unauthorized, the likelihood of an involuntary bankruptcy being filed against the borrower is minimized. These structures also aim to minimize the risk that the borrower will be "substantively consolidated" into other entities in bankruptcy by requiring the borrower to act as a "separate entity" through a promise to comply with a variety of "separateness covenants." These covenants typically require the borrowing entity to hold itself out as a separate legal entity, to hold assets and conduct business only in its own name, to observe legal entity formalities (annual meetings, officers, resolutions, etc.), to maintain separate books and records, to file separate tax returns, to have no other indebtedness or liens, to not commingle assets with others, to not transact business with affiliates except on an arms-length basis, and the like. Finally, bankruptcy remote structuring seeks to minimize the possibility of a borrower's voluntary bankruptcy by requiring the use of independent directors, and often by making the loan fully recourse to a parent entity, sponsor or principal should the borrower either file for bankruptcy or fail to observe the SPE separateness or other covenants. Lenders generally make their loans fully recourse through "bad boy" guaranties, often referred to as "springing guaranties" or "non-recourse carve-out guaranties."

The question is, how effective have bad boy guaranties been in the current down-cycle. As cases wind their way through the court system across the country, the initial results are in, and the trend clearly seems to be in favor of lenders successfully enforcing these springing recourse documents. While the results of any particular case will depend on many factors, including the wording of the guaranty in question, many courts have held in favor of lenders in light of the sophisticated nature of the parties and the plain, "unambiguous" language in the guaranties.

It should, of course, be pointed out that it is typical for these bad boy guaranties to have two sets of triggers. Upon the occurrence of one set of triggers, such as the failure of the borrower to comply with the required SPE covenants, recourse to the entire loan may spring against the guarantor. Yet upon the occurrence of another set of triggers, such as the failure to pay real estate taxes, the recourse may be limited to the loss or damage caused by the triggering event. We can expect future litigation over whether the triggering event falls into the first or second category, and if it is within the second category, over the quantum of the damages or losses sustained. Interestingly, many of the recent cases fall within the recourse for the entire loan category.

In a 2007 Massachusetts case, the borrower entered into a non-recourse CMBS mortgage loan, which was guaranteed by two individuals. The mortgage contained the typical "carve-outs" from the non-recourse language. The borrower defaulted on the loan by missing two monthly payments of principal and interest, and also by failing to put into the borrower's bank account a $2 million payment it received as part of a settlement of a zoning dispute with an adjacent property owner. The lender foreclosed, creating a deficiency claim of over $10 million, which the lender sought in full from the guarantors. After a jury trial, the court ruled in favor of the lender on all counts. The court found that the borrower's acceptance of the zoning settlement funds was an unauthorized transfer of the mortgaged property (under the particular definitions within the loan documents, mortgaged property included causes of action such as the zoning dispute that related to the real property) without the prior consent of the lender. The court found the unauthorized transfer constituted an event of default and triggered full recourse liability. Interestingly, the court went on to find that the guarantors were also fully liable because the borrower failed to strictly observe the SPE separateness covenants contained in the loan documents, by commingling the $2 million zoning settlement with other funds held by the guarantors, and by violating the loan document requirement that it maintain a participating independent director at all times. This could be described as a huge victory for the lender.

In a 2009 New Jersey Appellate Division case, the mortgage loan at issue became fully recourse to the guarantors when the borrower failed to obtain the lender's consent before obtaining secondary financing that encumbered the mortgaged property—in express violation of the loan terms. The borrower did, in fact, obtain subordinate financing on the property, but the financing was satisfied before the senior mortgage loan went into default. In fact, the only way the first mortgagee became aware of the prior subordinate financing was through the failure of the lawyers involved to remove the subordinate mortgage of record. Notwithstanding arguments that full recourse would be "unfair and unjust," constituted impermissible liquidated damages, and was an unenforceable penalty, the court held unanimously in favor of the lender.

In a New York case, summary judgment was issued for a lender against the recipient of a non-recourse loan and its partners. A provision in the loan agreement made the partnership and its individual partners personally liable for the loan if, among other things, the partnership filed for bankruptcy and the bankruptcy proceeding was not dismissed within 90 days. The borrower defaulted on the loan, the lender commenced foreclosure proceedings, and the borrower filed a voluntary petition in bankruptcy which was not dismissed until after the 90 day period. The appellate court found the guarantors fully liable on the deficiency. The court found that the bankruptcy default provision giving rise to full recourse liability did not violate public policy and that it was "neither inequitable, oppressive, or unconscionable."

In a 2009 case decided by an Ohio federal court, a lender refinanced a set of apartment complexes for a borrower, and three individuals entered into a guaranty that included certain "springing recourse events," which made the guarantors personally liable for the full amount of the loan if the borrower filed for bankruptcy. Two years into the loan, the borrower defaulted and thereafter filed for bankruptcy, staying the mortgage lender's foreclosure action. One month later, the bankruptcy court granted the lender relief from the bankruptcy automatic stay, allowing the lender to proceed with the foreclosure against the properties. The lender also sought to enforce the guaranty as a result of the bankruptcy filing and sought summary judgment against the guarantors. The guarantors argued, among other things, that the guaranty provisions were ambiguous and void as against public policy. The court found the guaranty provisions unambiguous. Moreover, the court held that the guaranty was not contrary to public policy, but rather that "the inverse [was] true." "Individuals are permitted to contractually obligate themselves to pay the debts of another and, if those debts are not paid, obtaining a judgment is the only manner by which a plaintiff can obtain a judicial declaration that the guarantors are indebted to the lender." The court rejected the guarantors' argument that the guaranty provisions placed them in an "untenable position" of choosing between exercising their rights under the Bankruptcy Code and protecting themselves, to the detriment of other creditors. The court rejected this argument, holding the guaranty "created liability for the individual guarantors—it did not prevent [the borrower] from seeking protection afforded by the Bankruptcy Code."

The Fourth Circuit also rejected a "public policy" argument for striking down a springing guaranty triggered by an affiliate bankruptcy. A similar case is currently being argued in New York, in connection with the ESH bankruptcy case, so it will be interesting to see if the New York court reaches a different conclusion from these other jurisdictions.

There are various other cases, typically holding in favor of the lenders, for springing recourse to guarantors for a variety of reasons, including breaching SPE covenants, placing subordinate debt on a mortgaged property, impairing the mortgage lender's recourse rights to its mortgage collateral, fraud and intentional misrepresentation, and misapplication or conversion of rents following an event of default. Notwithstanding numerous defenses and arguments raised by the guarantors—ranging from arguments that the breach of the trigger event was miniscule in relation to the full amount of recourse they picked up on the entire loan, to the fact that the events giving rise to full recourse may have been cured before the lender even sued the guarantor—the courts clearly seem to be of a mind, at least based on the cases to date, to find in favor of the lenders.

The lesson to be learned from the current cases is that events that give rise to springing full recourse should be taken, read, and negotiated seriously. Whether entering into a new loan transaction or purchasing a pool of performing or non-performing loans with springing recourse features, those features should not be shunted into the closet. As the guarantors in the above cases can attest, the consequences of these bad boy guaranties can be quite costly, and these provisions create an important "hammer" for the lenders to use if and when they need it.

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