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# Commercial Real Estate Financing 2017

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**“The Main Course Is...Recourse”—Guaranty  
Agreements in Commercial Real Estate  
Financing**

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## **A. GUARANTY AGREEMENTS- GENERALLY**

In the context of commercial real estate financing, a Guaranty Agreement (a “Guaranty”) is often required by a lender in order to enhance the scope of the lender’s recoverability rights with respect to the related mortgage loan.<sup>3</sup> While a commercial real estate lender traditionally will look to the mortgaged property for recovery in the event of a default under a mortgage loan, a Guaranty provides an additional avenue for recovery. The borrower’s principals will typically guaranty the mortgage loan and the lender can seek recovery under the Guaranty in addition to pursuing remedies under the mortgage.<sup>4</sup>

While there are many types of Guaranties entered into in connection with a commercial real estate financing, each Guaranty, regardless of scope or type, will typically contain, among other things, the following provisions:

- (i) the scope, conditions and limitations of the obligation which is guaranteed (i.e., payment, completion, and springing obligations);
- (ii) consideration for the execution of the Guaranty (benefit received by the guarantor is typically associated with the related mortgage loan); and
- (iii) covenants relating to the enforcement of the obligation which is guaranteed.<sup>5</sup>

This article will focus on the following three types of Guaranties associated with commercial real estate financing transactions: (i) Full Recourse Guaranties, (ii) Completion Guaranties and (iii) Nonrecourse Carveout Guaranties and the common provisions contained therein.

## **B. FULL RECOURSE GUARANTIES**

Although the property in a commercial real estate financing is often considered the true security for a commercial real estate loan, to hedge risk and enhance credit, a lender may require a Full Recourse Guaranty from

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3. “COMMERCIAL LOAN GUARANTIES AND ENFORCEMENT OF NON-RECOURSE CARVE-OUT LIABILITY” by Lauren Beslow, Commercial Loan Guaranties and Enforcement of Non-Recourse Carve-Out Liability, 20 Westlaw Journal Bank & Lender Liability 1 (2014).

4. *Id.*

5. *Id.*

the borrower's principals.<sup>6</sup> A Full Recourse Guaranty will often contain the following provision which is operative in creating the unconditional Guaranty: "Guarantor hereby irrevocably and unconditionally guarantees to lender the payment and performance of the Guaranteed Obligations as and when the same shall be due and payable, whether by lapse of time, by acceleration of maturity or otherwise. Guarantor hereby irrevocably and unconditionally covenants and agrees that it is fully and personally liable for the Guaranteed Obligations as a primary obligor as set forth herein."

As referenced above and in the context of a Full Recourse Guaranty, the "Guaranteed Obligation" is the repayment of all outstanding principal, interest and other amounts due and owing under the related loan. Additionally, a Full Recourse Guaranty will often define the scope and nature of the Guaranty as being "an irrevocable, absolute, continuing guaranty of payment and performance and not a guaranty of collection" and will typically continue to be effective after the death of the guarantor. Drafting an unconditional Full Recourse Guaranty which is "absolute, irrevocable and continuing" helps to streamline enforcement of remedies under the Guaranty by the lender as the unconditional nature of a Guaranty which is "absolute, irrevocable and continuing" has been deemed to constitute a waiver of affirmative defenses which may be asserted by a guarantor in defense of collection on the applicable Guaranty.<sup>7</sup>

Full Recourse Guaranties are often utilized in the commercial lending space for unfamiliar or special property types, or in instances where income at a property has not been stabilized enough to satisfy underwriting requirements. Furthermore, in the context of construction lending, Full Recourse Guaranties may be utilized to protect a construction lender.

### **C. COMPLETION GUARANTIES**

A Completion Guaranty is a type of Full Recourse Guaranty which is meant to enhance the security of a lender in the context of a commercial construction loan and "provide the lender with additional comfort that losses may be recovered to the extent that a financed project is not completed

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6. 1 Law of Real Estate Financing § 5:5 The Law of Real Estate Financing November 2016 Update by Michael T. Madison, Jeffrey R. Dwyer, Steven W. Bender. Chapter 5. Postconstruction (Permanent) Financing.

7. See HSH NORDBANK AG NEW YORK BRANCH, as Administrator Agent for Itself and Certain Lenders, Plaintiff–Appellee, v. Brian STREET, James Cohen, Defendants–Appellants HSH Nordbank AG N.Y. Branch v. St., 421 F. App'x 70 (2d Cir. 2011).

(i) in accordance with the approved plans and specifications, (ii) free and clear of all mechanic's liens or (iii) on time and within budget.”<sup>8</sup>

Completion Guaranties are also of an unconditional nature and are “absolute, irrevocable and continuing.” A Completion Guaranty will contain many of the same provisions as other Full Recourse Guaranties, with several distinctions, mainly with respect to the obligation which is guaranteed. The guaranteed obligation set forth in a Completion Guaranty is unique as a Completion Guaranty “does not guarantee a borrower’s payments, but rather the completion of a construction project, should the borrower be unable to complete the project.”<sup>9</sup>

Due to the nature of the guaranteed obligation in a Completion Guaranty, there are several factors to consider when drafting or negotiating the Completion Guaranty that will not arise in other forms of Guaranties. The most common difference among lenders requiring a Completion Guaranty is how the lender addresses a guarantor’s liability for undisbursed loan proceeds which have not been drawn upon during the term of the construction loan. For example, see the highlighted portion of the provision below:

“Without limiting any of Lender’s right hereunder or under any of the Loan Documents or the Other Loan Documents, whether or not Lender shall elect to exercise its rights under the Loan Documents or the Other Loan Documents to Complete the Project, Lender shall have the option, in its sole and absolute discretion, exercisable from and after the date when Lender shall be entitled to cause Guarantor to pay or perform the Guaranteed Obligations hereunder, to require Guarantor to pay to Lender, as Guarantor’s sole liability for payment and performance of the Guaranteed Obligations and as liquidated damages, an amount equal to the sum of (i) all Projected Cost Overruns (as defined below), less (ii) any amounts then held by Lender and delivered by Borrower in connection with curing of any Balancing Event. Such payment shall be due no later than ten (10) Business Days following Lender’s written demand therefor. If Lender elects to receive such payment under this Section, such payment shall be as liquidated damages, and not as a penalty, the parties agreeing the estimation of Lender’s actual damages on account of Borrower’s and Guarantor’s failure to Complete the Project would be difficult to estimate. Nothing in this Section shall limit Guarantor’s obligations

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8. 25 No. 5 Prac. Real Est. Law. 21 Practical Real Estate Lawyer September 2009 Thomas Hanahan, Reconsidering Completion Guaranties Completion Guaranties Pose a Variety of Coverage and Enforcement Issues that Can Limit their Practical Benefit, Prac. Real Est. Law., September 2009, at 21.
  9. 63 N.Y. Jur. 2d Guaranty and Suretyship § 84 New York Jurisprudence, Second Edition November 2016 Update Guaranty and Suretyship, Christine M. G. Davis, J.D., LL.M.; Thomas M. Fleming, J.D.; John A. Gebauer, J.D.; John Kimpflen, J.D.; Caralyn M. Ross J.D.; Eric C. Surette, J.D.; and Judy E. Zelin, J.D. II. Creation and Existence of Relation D. Kinds of Guaranty Contracts 2. Particular Contracts § 84. Completion Guaranty 63 N.Y. Jur. 2d Guaranty and Suretyship § 84.

under Section [4] below. As used herein, the term “**Projected Cost Overruns**” means the excess, if any, of (A) all costs of Completing the applicable Project estimated by Lender as of the date Lender demands payment by Guarantor under this Guaranty (even if Lender does not intend to Complete the Project) free of Liens (other than the Liens of the Loan Documents), minus (B) without duplication of amounts deducted above, the amounts then contained in any Reserve Account pursuant to the Loan Agreement that would have otherwise been available to Borrower to pay for the cost of the Project, minus (C) the unadvanced amount of funds that would have otherwise been available to Borrower as an Additional Advance to pay for the cost of the Project pursuant to the terms and conditions of the Loan Agreement.”

In the example above, as is the case in most Completion Guaranties, the lender has the right to cause the guarantor to complete the construction project in order to realize its intended collateral package at the onset of the transaction (i.e., a fully completed project). However, while the guarantor under the Completion Guaranty is liable for the costs incurred in such completion, the total liability of the guarantor is reduced by the amount of loan proceeds not yet disbursed.

Some lenders will not give this “credit” for the undisbursed proceeds and this can be a point of contention at the loan document negotiation phase. At the term sheet phase, all of the “nuts and bolts” of a Completion Guaranty are usually not discussed, as the term sheet will simply state that a Completion Guaranty is required.<sup>10</sup> It can be expected that during loan document negotiation, sophisticated borrowers and their counsel will push hard to receive credit for undisbursed loan proceeds.<sup>11</sup>

#### **D. NONRECOURSE CARVEOUT GUARANTIES**

Nonrecourse Carveout Guaranties are utilized in commercial real estate loans which are “nonrecourse” in nature. Nonrecourse loans are loans in which a lender’s recovery (following the default of a borrower) is strictly limited to remedies (i.e., foreclosure, deed in lieu of foreclosure or other lender remedies) related to the real property serving as security for the loan.<sup>12</sup> However, many (if not all) lenders require that, in connection with a nonrecourse loan, the borrower’s principal(s) enter into a Nonrecourse Carveout Guaranty which provides that the loan becomes recourse

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10. Thomas Hanahan, *Reconsidering Completion Guaranties Completion Guaranties Pose a Variety of Coverage and Enforcement Issues that Can Limit their Practical Benefit*, *Prac. Real Est. Law.*, September 2009, at 21.

11. *Id.*

12. 1 *Real Estate Transactions: Structure and Analysis with Forms* § 4:51 *Real Estate Transactions - Structure and Analysis with Forms*, August 2016 Update: Alvin L. Arnold.

to the borrower (and its principal) to the extent that certain events occur and “spring” recourse into effect. These certain events are often called “bad-boy” acts as they historically were based solely on malfeasance by the borrower with respect the property. However, the scope of the events which “spring” recourse have broadened into some actions which may not be in the borrower’s control.<sup>13</sup> In loan documents, the acts or occurrences which spring recourse to the borrower (or its principal) are called “carveouts” and can be broken down into two main categories: (i) those actions or occurrences which bring about limited (losses) recourse liability to the borrower and its principal and (ii) those actions or occurrences which bring about full recourse liability to the borrower and its principal.<sup>14</sup> The remainder of this article will discuss each of these types of “carveouts”.

### **1. Limited Recourse (“Losses”) Carveouts**

Generally, a nonrecourse loan will be evidenced by loan documents which provide, among other things, that the lender shall not seek a deficiency or monetary judgment against the related borrower (and subsequently the guarantor) other than in connection with a foreclosure action or other action related solely to the mortgaged property which serves as collateral. However, limited recourse carveouts or “losses” carveouts, will provide that a lender shall have the right to seek monetary judgment against the borrower (and guarantor) to the extent that such lender incurs losses arising out of or in connection with certain events. “Losses” carveouts are typically called “above-the-line” carveouts, and a standard (but not fully inclusive) list of actions or events which could trigger “losses” liability and recourse is set forth below.<sup>15</sup>

Losses arising out of or in connection with the following:

- a. fraud or intentional misrepresentation by the borrower (or nonrecourse carveout guarantor) in connection with the loan;
- b. the gross negligence or willful misconduct of the borrower (or nonrecourse carveout guarantor);

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13. See generally *Heller Fin., Inc. v. Lee*, No. 01 C 6798, 2002 WL 1888591 (N.D. Ill. Aug. 16, 2002).

14. *Mortgage and Asset Backed Securities Litigation Handbook* § 5:74 *Mortgage and Asset Backed Securities Litigation Handbook*, November 2016 Update, Talcott J. Franklin and Thomas F. Nealon III.

15. Note: varying lenders will have carveouts which may be worded differently, but each lender will generally consider the same actions/omissions of a borrower with respect to the property in determining carveout liability.



- c. material physical waste of the property;
- d. the removal or disposal of any portion of the property after an event of default (under the loan);
- e. the misapplication or misappropriation of rents, insurance proceeds, condemnation awards or security deposits relating to the property; and
- f. failure to pay charges for labor or materials or other charges or judgments that can create liens on any portion of the property.

Due to the fact that a borrower (and its principal) may be exposed to recourse liability under the provisions above, and in light of recent litigation affecting the nonrecourse market (most commonly as set forth in Wells Fargo Bank, N.A. v. Cherryland Mall<sup>16</sup>), “losses” carve-outs are often heavily negotiated in the loan documents evidencing a commercial real estate financing. Based on what is commonly known as the “Cherryland Mall” type revisions (revisions which impose liability only to the extent that sufficient cash flow is available from the property to comply with a covenant set forth in the loan documents) and other standard negotiations, a borrower may request to negotiate some of the standard “losses” carveouts to read as follows:

- a. the gross negligence or willful misconduct of the borrower; provided, however, borrower’s failure to perform any obligation under the Loan Documents shall not be construed as gross negligence or willful misconduct if Borrower (or the nonrecourse carveout guarantor) is required to expend any sum of money in order to perform the obligation in question and there was (a) insufficient Available Cash Flow to allow Borrower (or the nonrecourse carveout guarantor) to perform the obligation or (b) sufficient Available Cash Flow to perform such obligations, but Lender or a receiver was in control of such revenue and did not allow it to be used to allow Borrower (or the nonrecourse carveout guarantor) to perform the obligation in question;
- b. material physical waste of the property caused by acts or omission of Borrower (or the nonrecourse carveout guarantor) or any Affiliates of Borrower (or the nonrecourse carveout guarantor); provided,

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16. 812 N.W.2d 700 (Mich. Ct. App. 2011) holding that the violation of a covenant for the special purpose entity borrower to remain solvent regardless of the economic climate of the property which was backstopped by a full recourse guaranty did in fact trigger full recourse as required by the loan documents.

however, there shall be no liability for physical waste if such occurs during a time when there was (a) insufficient Available Cash Flow to prevent such waste or (b) sufficient Available Cash Flow to prevent such waste, and such waste was preventable by the payment of money, but Lender or a receiver was in control of such revenue and did not allow it to be used to prevent such waste after request therefor was made by Borrower; and

- c. failure to pay charges for labor or materials or other charges or judgments that can create Liens on any portion of the Property; provided, however, that unless Borrower incurred such charges after the occurrence and during the continuance of an Event of Default, there shall be no liability for such failure to pay if it occurs during a time when there was (a) insufficient Available Cash Flow to prevent such failure to pay or (b) sufficient Available Cash Flow to prevent such failure to pay, but Lender or a receiver was in control of such revenue and did not allow it to be used to prevent such failure to pay after request therefor was made by Borrower.

While revisions to the “losses” carveouts above may be requested by a borrower and its counsel, it is not guaranteed that a lender will agree to any such revisions. The circumstances surrounding a property, the ultimate destination of the loan (whether it is to be held by a lender or sold in the secondary market), and other credit factors may determine whether or not a lender will accommodate the above-negotiated provisions.<sup>17</sup>

## **2. Full Recourse Carveouts**

Unlike “losses” carveouts which bring limited recourse to the borrower (and its principal) in connection with certain actions or events only to the extent of losses incurred by the lender, full recourse carveouts provide that the loan is fully due and payable by the borrower (and its principal) to the extent that certain actions or events occur. Standard full recourse carveouts for nonrecourse loans are set forth below:

Lender’s agreement to not pursue monetary judgment against the borrower (or its principal) SHALL BECOME NULL AND VOID and

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17. See generally: SV046 ALI-CLE 85 NONRECOURSE CARVEOUT GUARANTIES IN COMMERCIAL LOANS: DRAFTING TIPS TO AVOID UNINTENDED LIABILITIES.

shall be of no further force and effect and the debt shall be fully recourse to Borrower (and its principal) in the event:

- a. of a breach by Borrower of any of the representations, warranties and covenants regarding its status as a special purpose entity as required by the loan documents;
- b. Borrower fails to pay the first installment of monthly principal and interest payments;<sup>18</sup>
- c. Borrower incurs any Indebtedness other than the Debt and Permitted Debt without the prior written consent of Lender;
- d. of the occurrence of a transfer in violation of the loan documents;
- e. the Property or any part thereof shall become an asset in a bankruptcy or insolvency proceeding initiated by Borrower;
- f. Borrower (or its principal) and any officer, director, or representative which Controls, directly or indirectly, Borrower (or its principal) files, or joins in the filing of, an involuntary petition against Borrower under any Creditors Rights Laws, or solicits or causes to be solicited petitioning creditors for the filing of any involuntary petition against Borrower from any Person under any Creditors Rights Laws;
- g. Borrower (or its principal) making an assignment for the benefit of creditors, or admitting in writing or in any legal proceeding, its insolvency or inability to pay its debts as they become due;
- h. Borrower (or its principal) files an answer consenting to or otherwise acquiescing in or joining in any involuntary petition filed against it, by any other Person under any Creditors Rights Laws, or solicits or causes to be solicited petitioning creditors for any involuntary petition from any Person; or
- i. any affiliate, officer, director, or representative which controls Borrower (or its principal) consents to or acquiesces in or joins in an application for the appointment of a custodian, receiver, trustee, or examiner for Borrower or any portion of the Property.

These full recourse carveouts (also called “below-the-line” carveouts) are meant to deter borrower actions (or inactions) which would materially alter the collateral which is serving as security for the loan.

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18. Not all lenders require recourse for the failure to make a payment of the first monthly payment.

Like “losses” carveouts, full recourse carveouts are often heavily negotiated as a borrower and its principal are seeking to limit their liability in the event that the property “goes south”. Some of the most commonly negotiated “full recourse carveouts” including proposed revisions by counsel are set forth below:

Lender’s agreement to not pursue monetary judgment against the borrower (or its principal) SHALL BECOME NULL AND VOID and shall be of no further force and effect and the debt shall be fully recourse to borrower (and its principal) in the event:

- a. of a breach by Borrower of any of the representations, warranties and covenants regarding its status as a special purpose entity as required by the loan documents and such a breach is cited as a factor in a court’s decision that results in a substantive consolidation (other than a substantive consolidation petitioned for or joined in by Lender) of the Borrower with any other Person in a proceeding under any Creditors’ Rights Law;<sup>19</sup>
- b. Borrower incurs any Indebtedness other than the Debt and Permitted Debt without the prior written consent of Lender; provided, however, that there shall not be recourse liability for failure to pay trade payables<sup>20</sup>, provided that (I) such trade payables were reasonable and customary and entered into the ordinary course of business with a third party on market terms, and (II) such failure to pay trade payables is due to (x) insufficient Available Cash Flow revenue from the Property to allow Borrower to pay the trade payable or (y) there was sufficient Available Cash Flow to perform such obligations, but Lender or a receiver was in control of such revenue and did not allow it to be used to allow Borrower to pay such trade payables;<sup>21</sup>

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19. Note that some lenders will agree to bifurcate this provision into (i) a “losses” carveout for a breach of a representation, warranty or covenant relating to special purpose entity requirements of the borrower and (ii) a full recourse carveout for the citing of the breach as a factor in the substantive consolidation of the borrower.

20. Note that most lenders permit borrowers to incur trade payables in the ordinary course of business which do not exceed 2% of the total outstanding principal loan amount.

21. This is another “Cherryland Mall” comment as the borrower is seeking to reduce recourse exposure to the extent that the property does not produce income as expected.

- c. Borrower (or its principal) making an assignment for the benefit of creditors, or admitting in writing or<sup>22</sup> in any legal proceeding, its insolvency or inability to pay its debts as they become due; and
- d. Borrower (or its principal) files an answer consenting to or otherwise acquiescing in or joining in any involuntary petition filed against it, by any other Person under any Creditors Rights Laws, or solicits or causes to be solicited petitioning creditors for any involuntary petition from any Person; provided, however, (I) Borrower may acquiesce or file an answer consenting to any such action if brought by Lender and (II) Borrower's failure to contest such an involuntary petition where no meritorious defenses exist shall not be deemed to be consent or acquiescence for the purposes of this subsection (d).

As discussed above in the section on “losses” carveouts, many factors will determine the extent to which a lender is willing to limit carve-out liability. However, it is likely that some of the heaviest negotiation relating to nonrecourse loan documents are related to the full recourse carveout section.

## **E. CONCLUSION**

Recourse liability to a borrower or its principal is an important credit enhancement for lenders in commercial real estate financings. While there is little or no “wiggle” room in negotiating Full Recourse Guaranties and Completion Guaranties (other than as set forth above), the negotiations surrounding Nonrecourse Carveout Guaranties are typically the main focus of loan document negotiation in nonrecourse lending. Having an understanding of the borrower’s obligations under all forms of guaranties, however, can prove to be helpful in negotiating provisions on behalf of a borrower or lender.

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22. This negotiation is very nuanced. A borrower does not want to back itself into full recourse liability to the extent that the borrower reaches out to the loan servicer for either (i) an extension or (ii) payment work out plan in the event that it is unable to pay debt service. Any email or other written communication could be considered “an admission in writing” of insolvency.

## NOTES

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