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NO GOOD BOY GOES UNPUNISHED UNDER A BAD BOY GUARANTY

Thomas M. Whelan

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I. INTRODUCTION

A. Bad Boy Guaranties Sometimes Punish Good Boys

The colloquial term—bad-boy guaranty—leaves some to believe that only bad acts by the borrower or guarantor trigger bad boy liability. Too often this belief is mistaken. While some non-recourse carveouts impose fault-based liability for truly bad acts committed by bad actors affiliated with the borrower, others essentially impose strict liability on the carveout guarantor when bad things happen without regard to any wrongdoing by the borrower or guarantor.[1] The difference between fault based and strict liability carveouts can make a big difference in the risks faced by a carveout guarantor during the enforcement process after a default. This section of the materials concentrates on minimizing carveout liabilities once an event of default occurs and the enforcement process begins.

B. What is the Non-Recourse Deal?

The legal terms of a non-recourse loan should reflect the underlying economic bargain. This begs the question: what bargain does a given set of non-recourse carveouts reflect?

If the bargain is that the mortgage holder really agrees to look solely to the collateral for repayment of the loan as long as ***the borrower and its affiliates*** do not obstruct the holder's recourse to the collateral or act wrongfully to impair the its value, then—other things being equal—fault based carveouts (bad borrower related actors doing bad things) reflect the deal.

If the mortgage holder agrees to look to the collateral for repayment of the loan, but the borrower and guarantor also agree to pay losses or to pay the loan if certain bad things just happen—even if the borrower and its affiliates do nothing to obstruct the holder's recourse to the collateral or to impair its value—then strict liability (bad event) carveouts reflect the deal.

Both types of loans are nominally non-recourse, but the liability risks to the carveout guarantor are materially different once a default occurs and the enforcement process begins. Even so, careful planning in anticipation of a probable default and prudent negotiation once a default occurs can reduce those risks even when the loan documents otherwise impose strict liability on the carveout guarantor.

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[1] **Appendix 1**: Chart comparing fault based (Bad Actor) carveouts with strict liability (Bad Event) carveouts. As a general proposition, a Bad Actor carveout triggers guarantor liability when a Bad Actor related to the borrower does a Bad Thing. A Bad Event carveout triggers guarantor liability when a Bad Event occurs in the absence of any misdeed by the borrower or guarantor.

Appendix 2: Redline of Agreed Order Appointing Receiver. The redline shows modifications requested by a carveout guarantor and agreed to by the mortgage holder in different receivership proceedings. In the trough of the recent debt crisis, servicers and mortgage holders were willing, in many cases, to agree to such modifications in exchange for the borrower's agreement not to demand that the court compel the mortgage holder to foreclosure promptly.

C. Develop a Default Checklist

The primary interest of the guarantor of a non-recourse loan is avoiding personal liability under the non-recourse carve-outs and springing recourse provisions in the loan documents. To vindicate this interest, it is best to have a plan developed with the input of someone who understands the loan documents (an office lawyer), the borrower's operations (the borrower's representative), the debt enforcement process (a courtroom lawyer), and the potential conflicts between the borrower and the carveout guarantors (everyone).

CARVEOUT LIABILITY AVOIDANCE CHECKLIST

- Map the Carveout Minefield
  - Review the Loan Documents
    - Defaults and events of default
    - Lender's right to appoint receiver
    - ***Application and use of rents and revenues*** (before and after default or event of default)
    - Recourse Liabilities
    - Full Recourse Events
    - Gather carveout related documents
      - Insurance policies and outstanding claims
      - Tax statements and escrow accounts
      - Contracts
        - With affiliates
        - With rights to lien property
      - Payables
      - Reports to lender
      - Deferred maintenance assessments
      - Other documents evidencing or referring to carveout matters
  - Review the loan related documents
    - Pooling and Servicing Agreements
    - Intercreditor Agreements
    - Mezzanine Loan Documents
    - Correspondence
- Chart the Conflicts
  - Who are the relevant participants and what conflicts and potential conflicts exist between and among these participants?
  - Who represents whom?
    - Borrower
      - Are agents of borrower or its constituents wearing more than one hat?
      - Borrower constituents? (e.g., general partner, manager, etc.)

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Also available as part of the eCourse
Recourse Carve-Out Liability; plus Construction Completion Guaranties and Master Leases

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