**At a Glance**

**450**

**Attorneys & Professionals Firmwide**

**9**

**Office Locations Nationally**


Manatt is known for quality, for extraordinary commitment to clients, for integrated, relationship-based services, and for a range of capabilities typically found only in boutique firms. We are progressive and entrepreneurial compared to other major firms, and we are deeply committed to diversity, to public service, to involvement in the communities we serve and to excellence in all we do.

We are proud to represent a sophisticated client base in a range of industries, including healthcare, financial services, entertainment, media and advertising, real estate, technology, energy and natural resources, consumer goods and services, and transportation.

Industries:

Energy

Entertainment and Media

Financial Services

Manatt Health

Real Estate

Retail and Consumer Products

Services:

Business Strategy and Consulting

Corporate and Finance

Government and Regulatory

Litigation

Media, Technology and Advertising

manatt

# “Bad Boy” Guaranties–Enforceable or Not?

**Oct. 18, 2017**

Barry Lee| Partner, Manatt, Phelps & Phillips, LLP
Jubin Meraj | Partner, Manatt, Phelps & Phillips, LLP

# “Bad Boy” Guaranties–Enforceable or Not?



- Topic Overview
  - The History and Purposes of “Bad Boy” Guaranties
  - Common Provisions in Bad Boy Guaranties
  - Seminal Cases
  - Drafting More Enforceable Provisions
  - Q&A

# The History and Purposes of "Bad Boy" Guaranties



- Definitional Matters
  - "Non-recourse Loan" - a secured loan for which the lender has agreed it will seek to be repaid from only the mortgaged property
  - "Bad Boy" Guaranty - a guaranty that holds the guarantor personally liable for either lender's losses, or the entire amount of the loan, if certain "bad boy" events occur

# The History and Purposes of "Bad Boy" Guaranties



- Uses of "Bad Boy" Guaranties Pre-CMBS and Post-CMBS
  - Prior to CMBS, "bad boy" events–to the extent they were used–generally were egregious acts (like fraud and gross negligence) within the control of the guarantor
  - CMBS loans added failure to pay taxes and insurance, allowing liens to be placed on the property, failure to provide financial statements, and similar triggers
  - Bankruptcy was added to the list in the real estate recession of the 1990s; it was used as a strategy to delay the lender's exercise of nonjudicial foreclosure remedies
  - Rating agencies such as S&P and Moody's required each borrower to be an SPE with numerous separateness covenants

# The History and Purposes of "Bad Boy" Guaranties



- Today "Bad Boy" Guaranty = misnomer
- "Bad Boy" carve-outs in other contexts: joint ventures (change in management control provisions) and development management agreements (for construction companies with few assets)

# Common Provisions in Bad Boy Guaranties



- "Actual Loss" versus "Full Recourse" Triggers
  - "Actual Loss"/ "Above the Line"–guarantor has liability for the actual losses incurred by a lender resulting from the triggering event
  - "Full Recourse" / "Below the Line"–guarantor becomes liable for the entire amount of the debt (i.e., any deficiency)
  - What determines which trigger goes above or below the line?

# Common Provisions in Bad Boy Guaranties



- List of Typical "Actual Loss" Triggers
  - Fraud by borrower or its affiliates
  - Misappropriation of funds by borrower or its affiliates
  - Gross negligence or willful misconduct
  - Waste
  - Failure to pay contractors or suppliers, which may result in liens

# Common Provisions in Bad Boy Guaranties



- List of Typical "Full Recourse" Triggers
  - Bankruptcy events (voluntary bankruptcy, collusive involuntary bankruptcy)
  - Prohibited transfers/encumbrances of the property
  - Insolvency
  - Borrower admits in writing it is unable to pay its debts as they become due
  - Violation of the SPE/separateness covenants, such as engaging in business other than operation of the property, merger with any other person, failure to maintain separate accounts books and records, failure to maintain separate legal formalities, and failure to pay its own liabilities from its own accounts
    - Intended to avoid substantive consolidation in bankruptcy
    - Why would a secured lender who made a non-recourse loan be worried about substantive consolidation? The lender does **not** lose the security interest as a result

# Seminal Cases



- General Trends
- The Insolvency Cases – *Gratiot* and *Cherryland Mall*
- Settlement Agreement as Prohibited Transfer – *Blue Hills Office Park*
- Failure to Pay Real Estate Taxes – *Park Avenue Hotel Acquisition*
- "Waste" cases
- Contesting Enforcement Actions – *Bank of America v. Freed*
- IRS General Legal Advice Memorandum re Bad Boy Guaranties

# Seminal Cases



- General Trends in the Cases
  - Lenders prevail against guarantors and borrowers
  - Courts generally enforce the express provisions of the guaranties, even if there is parol evidence suggesting that the parties' intent was not consistent with the express provisions

# Seminal Cases



- *51382 Gratiot Ave. Holdings, LLC v. Chesterfield Development Co., LLC*, 835 F. Supp. 2d 384 (E.D. Mich. 2011)
  - In April 2005, Chesterfield Development Co. borrowed $17MM in a commercial loan from Morgan Stanley, who later sold the loan to Gratiot
  - In November 2009 Borrower ceased making mortgage payments because the project was failing
  - The lender put the borrower in default, accelerated the debt and foreclosed on the property, which was sold for only $7.6MM, leaving a $9MM deficiency
  - The court held that the express language of the guaranty controls

# Seminal Cases



- *51382 Gratiot Ave. Holdings, LLC v. Chesterfield Development Co., LLC*, 835 F. Supp. 2d 384 (E.D. Mich. 2011)
  - Defenses to Enforceability
    - "Extremely absurd," "ridiculous" and "draconian" result
    - Mutual mistake
    - Public policy
      - "[t]he court does not sit to propagate or enforce best business practices; instead, it is the court's duty to give effect to discrete agreements executed by individual parties… the court will hold those parties to their bargain."
      - Related case – *UBS Commercial Mortgage Trust 2007-FL1, Commercial Mortgage Pass-through Certificates, Series 2007-FL1, and Normandy Reston Office, LLC v. Garrison Special Opportunities Fund L.P.* (N.Y. Sup., March 8, 2011)
        - "No doubt that there are many real estate developers who now regret having exposed themselves to the loss of fortune by investing in an overheated real estate market … However, the Court is not a bank, insurance or pension fund regulatory authority with the administrative power required to address these circumstances. The Court is an arbiter of commercial disputes, charged with upholding freely entered into contractual arrangements in accordance with common law precedents and the rules of legislative interpretation."

# Seminal Cases



- *51382 Gratiot Ave. Holdings, LLC v. Chesterfield Development Co., LLC*, 835 F. Supp. 2d 384 (E.D. Mich. 2011)
  - Other possible defenses
    - Unenforceable penalty
    - Invalid liquidated damages
    - Unconscionability
    - Fraud in the inducement

# Seminal Cases



- *Wells Fargo Bank, NA v. Cherryland Mall* (Mich. Ct. App. 2011)
  - As a result of this case, the Michigan Legislature passed the Nonrecourse Mortgage Loan Act of 2012 (NMLA)
    - "A post closing solvency covenant shall not be used, directly or indirectly, as a nonrecourse carveout or as the basis for any claim or action against a borrower or any guarantor or other surety on a nonrecourse loan."
    - "… applies to the enforcement and interpretation of all nonrecourse loan documents in existence on, or entered into on or after, the effective date of this act."
    - The Michigan Supreme Court, in 2012, remanded the *Cherryland* case for reconsideration in light of the NMLA and the judgment against the guarantor was overturned
  - "We recognize that our interpretation seems incongruent with the perceived nature of a nonrecourse debt and are cognizant of the amici curiae's arguments and calculations that, if accurate, indicate economic disaster for the business community in Michigan if this Court upholds the trial court's interpretation. Nevertheless, the documents at issue appear to be fairly standardized nationwide, and defendants elected to take that risk—as did many other businesses in Michigan and nationwide. It is not the job of this Court to save litigants from their bad bargains or their failure to read and understand the terms of a contract."

# Seminal Cases



- *Blue Hills Office Park LLC v. J.P. Morgan Chase Bank*, 477 F. Supp. 2d 366 (D. Mass. 2007)
  - "… wise counsel would have explained all the risks involved in so transferring the settlement funds, counseled against it, and pushed for disclosure to the Lender."
  - The court expressed "regret over the time, money, and resources that necessarily have been expended to correct this faulty settlement structure."

# Seminal Cases



- *ING Real Estate Finance (USA), LLC v. Park Avenue Hotel Acquisition, LLC*, 907 N.Y.S.2d 437 (N.Y. Sup., Feb. 24, 2010)
  - Borrower wins
  - "The question before the Court is whether, by the terms of the contract, the nineteen-day tardiness in paying less than $300,000 in property taxes triggers a full recourse obligation by the Guarantors of up to $90 million."
  - "… plaintiffs would have … defendants potentially liable for the entire debt of up to $145 million if the Borrower is just one day delinquent in paying a dollar in property taxes … Such an unlikely outcome could not have been intended by the parties, sophisticated commercial borrowers and lenders aided by competent counsel at the time of the drafting, and is impermissible under New York law …"

- The "Waste" Cases
  - Failure to pay insurance premiums can constitute waste when mortgage requires same. *Alden Park, LLC v. Anglo Irish Bank Corp.,* 2009 WL 499157 (ED Mich.)
  - Failure to pay real estate taxes is "waste." *Travelers Inc. Co. v. 633 Third Associates*, 14 F.3d 114 (2nd Cir. 1994)
  - Failure to renew an important parking lease (that provided necessary parking for a commercial building) is **not** waste because it does not impair the collateral or make it subject to a superior lien. *Boucher Investments, L.P. v. Annapolis West Ltd. Partnership*, 784 A.2d 39 (Md. Ct. Spec. App. 2002)
  - Borrower's changing the "flag" of the hotel from a Holiday Inn to a Clarion Hotel, which reduced appraised value of property, is **not** waste. *U.S. Bank, N.A., as Trustee, and Orix Capital Markets, L.L.C. v. American Realty Trust, Inc.*, 275 S.W.3d 647 (Tex. App. 2009, *pet. denied*)

# Seminal Cases



- *Bank of America, N.A. v. Freed*, 983 N.E.2d 509 (Ill. App. 2nd 2012)
  - Guaranty provided for full recourse if borrower contested an enforcement action. Borrower filed an interlocutory appeal objecting to the to appointment of a receiver and the court ruled that the appeal triggered recourse liability

# Seminal Cases



- *IRS General Legal Advice Memorandum AM2016-001* Released April 15, 2016
  - In response to Chief Counsel Advice 201606027 issued Feb. 5, 2016
  - "Typical" non-recourse carve-outs, as listed in the memorandum, will not cause an otherwise non-recourse liability to be treated as recourse for the purposes of determining the allocation of partnership liabilities for tax purposes

# Seminal Cases



- Conclusions From Cases
  - Express language will generally be enforced in many jurisdictions
  - Legal right ≠ economic sense
  - The role of the transactional lawyer is key

# Drafting More Enforceable Provisions



- Solvency and Separateness Covenants
  - Borrower ~~shall at all times~~ is solvent as of the date hereof and intends to remain solvent to the extent there are sufficient Project Revenues, provided that nothing herein shall obligate any person, including any Affiliate of the Borrower, to contribute any funds to Borrower for the purposes of complying with this subsection.
  - Borrower breaches any representations, warranties, or covenants regarding its status as a "special purpose entity" under the Loan Documents, provided, however, that any such breach shall not result in recourse liability to the borrower or the guarantor unless such breach is cited as a factor in a judicial action resulting in the application of the doctrine of substantive consolidation of the assets and liabilities of Borrower with those of any other person pursuant to Bankruptcy Code and related case law.
  - Borrower or Guarantor admits, in writing ~~or~~ in any legal proceeding, its insolvency or inability to pay its debts as they become due.
  - ~~Borrower or Guarantor admits, in writing or in any legal proceeding, its insolvency or inability to pay its debts as they become due.~~

# Drafting More Enforceable Provisions



- Gross Negligence and Willful Misconduct
  - The gross negligence or willful misconduct of Borrower; provided, however, borrower's failure to perform its obligations under the loan documents shall not constitute gross negligence or willful misconduct if such failure resulted solely from the fact that performing such obligations required the Borrower to make expenditures and Project revenues were insufficient to fund such expenditures.

# Drafting More Enforceable Provisions



- Failure to Pay Taxes and Assessments
  - Borrower's failure to pay any of the taxes, assessments or similar charges specified in the Security Instrument, provided that Borrower shall not have any liability under this subsection during any time that there was insufficient revenue from the Project to prevent such failure to pay.

# Drafting More Enforceable Provisions



- Waste
  - Material physical ~~waste of the Property~~ resulting from the acts or omissions of Borrower or Principal other than physical waste resulting from insufficient revenues from the Project.

# Questions?

# Thank you!




## Barry W. Lee

**Partner, Financial Services Litigation and Enforcement**

San Francisco: 415.291.7450

bwlee@manatt.com


**Education**

- **University of California, Hastings College of the Law, J.D.**
- **Duke University, B.A.**

## About

Barry W. Lee is a partner in the San Francisco office, co-chair of the Trial Practice Group, and co-chair of the Financial Services Litigation and Enforcement Group. He focuses on commercial litigation and has extensive jury and bench trial experience encompassing a variety of areas, including real estate, banking/lender liability, antitrust/unfair competition, consumer class actions, environmental, construction, probate, securities, products liability, and insurance coverage.

In addition to his trial work, Barry has been a contributing author to an antitrust treatise and has authored numerous articles and appeared as a speaker for the Practicing Law Institute on various topics, including trial practice, discovery, directors' and officers' liability, professional liability insurance for lawyers and accountants, and antitrust.

# Thank you!




## Jubin Meraj

**Partner, Real Estate**

Los Angeles: 310.312.4125

jmeraj@manatt.com


**Education**

- **Yale Law School, J.D.**
- **Brown University, B.A.**

## About

Jubin Meraj is a partner in the real estate practice group in the firm's Los Angeles office. Jubin's practice focuses on a wide variety of real estate transactions, including acquisitions and dispositions, joint ventures, tenancy-in-common agreements, development management agreements, construction contracts, architectural agreements, management agreements, ground leasing, retail leasing, financing, easements, restrictive covenants and settlement agreements.

As investor's counsel, Jubin works closely with clients to identify and mitigate key risks in a venture. Jubin structures transactions with attention to each stage of the investment lifecycle, from partnership formation, to major decisions relating to land acquisition, obtaining entitlements and financing, all the way through exit strategies. When representing developers and sponsors, Jubin is focused on finding efficient, practical and creative solutions to the myriad obstacles that often arise in maneuvering through the various phases of a project.