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You Don't Have to be a 'Bad Boy' to be Liable Under a 'Bad Boy' Guaranty

By Eva Klein, Esq.

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"Bad boy" guaranties in commercial real estate loans have been commonplace for many years. However, neither guarantors, nor lenders expect guarantors to incur liability unless a "bad boy" act is actually committed. Two recent cases, however, subjected guarantors to liability previously non-existent, and have thrown the entire CMBS (Commercial Mortgage Backed Securities) industry and other commercial loan markets into upheaval. But in direct response to industry outcry against these decisions, and while these cases remain on appeal, the Michigan Senate quickly passed the "Non-Recourse Mortgage Loan Act" (effective March 29, 2012), which offers relief from these misguided decisions.

Typically, commercial real estate loans are non-recourse against the borrower, and the lender's recovery is limited to the mortgaged real estate and any other collateral pledged by the borrower. As additional security for the loans, lenders often require "bad boy" guaranties from one or more principals of the borrower. "Bad boy" guaranties generally cover borrower acts such as waste, conversion of insurance proceeds, misuse of security deposits, violating SPE* requirements and becoming insolvent. The unprecedented decline in the real estate market has thrown assets "under water", which had been a risk that lenders understood and accepted. Until these recent decisions, that scenario would not have subjected borrowers on non-recourse loans to liability in excess of the value of a property, or triggered liability under "bad boy" guaranties. That expectation, however, no longer is a given.

In *Wells Fargo Bank v. Cherryland Mall*, decided by a Michigan state appellate court, and *51382 Gratiot Avenue Holdings v. Chesterfield Development Company*, decided by the Federal District Court, Eastern District, the courts found that when the assets of the SPE borrower fell below its liabilities (i.e. the value of the property falls below the then outstanding principal amount of the mortgage, among other factors), the borrower is deemed insolvent and the "bad boy" guaranty is triggered. The courts imposed liability on the guarantors notwithstanding that the borrower did not commit any "bad boy" acts. Under these decisions, a borrower can do exactly what it is supposed to do in accordance with the loan documents (other than the impossibility of staying current on its mortgage), and suddenly the "bad boy" guaranty kicks in and the guarantor could be liable for a huge deficiency.

In the *Cherryland* case, the borrower stopped making mortgage payments and the lender foreclosed on the property. The borrower did not fight the foreclosure and allowed the sale to go through. The lender then brought suit against the guarantor for a $12 million deficiency. The claim made against the guarantor was that there was a trigger of the "bad boy" guaranty due to the failure of the borrower to remain solvent and pay its debts as they became due. The guarantor argued that the insolvency provision was intended to prevent the borrower from converting or diverting assets, thus becoming unable to pay its debts, and was not meant to apply to a decrease in the value of the mortgaged property due to market conditions.

The Court, however, determined that according to the loan documents, it was clear and unambiguous that no willful act was required in determining whether the borrower was solvent, and that any failure to remain solvent was a violation of the SPE requirements. The Court did recognize, however, that its interpretation seemed "…. incongruent with the perceived nature of a non-recourse debt" and that "… it may lead to economic disaster for the business community." Nevertheless, the court was constrained by the unambiguous language in the loan documents to make the ruling.

Similarly, in the *Chesterfield* case, after the borrower stopped making payments on a loan, the lender filed a foreclosure action and asserted a separate claim under the guaranty for the deficiency. Specifically, the loan documents provided that the non-recourse clause would be null and void, if the borrower shall "become insolvent or fail to pay its debts and liabilities from assets as the same shall become due." Since the non-recourse provision was deemed null and void, the guaranty was triggered. The guarantor claimed in its defense that none of the parties, including the lender, intended for the mortgage debt to be one of the debts considered in the calculation of solvency, because to do so would defeat the purpose of the non-recourse nature of the loan. The Court rejected this argument.

The effects of these decisions could be calamitous for the real estate industry, at a time when recovery is critical to the economy. Recognizing the negative impact of these cases, the Non-Recourse Mortgage Loan Act was enacted. The Act prohibits a post closing insolvency from being used as a non-recourse carve-out, or as a basis for any claim against the borrower or guarantor. It further declares such provisions to be invalid and against public policy. In addition, the Act retroactively applies to all non-recourse loans now in existence and to any pending actions for which appeal rights have not been exhausted. The Act essentially overturns the decisions in *Cherryland* and *Chesterfield*, and is a welcome restoration of long-accepted practices and expectations of all parties to commercial real estate loans.

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* "SPE" is a sole purpose entity utilized to purchase commercial real estate. In CMBS transactions and many other loans, borrowers covenant, and guarantors guaranty , that borrowers will not become insolvent, or file bankruptcy, among other covenants.

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