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COMMERCIAL LENDING

Rethinking the Bankruptcy Springing Recourse Guaranty

By
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The efficacy and enforceability of the bankruptcy springing recourse guaranty in commercial real estate lending has been put through rigorous legal argument and judicial review over the course of the recent recession. In its most typical form, the bankruptcy springing recourse guaranty imposes full personal liability on a guarantor for the entire amount of an otherwise non-recourse debt if the borrower voluntarily files for bankruptcy, or colludes in an involuntary bankruptcy filing.

The purposes of the guaranty, in concert with special purpose entity covenants, are to ensure that a real estate borrower preserves the loan collateral's value exclusively for the benefit of the secured real estate lenders, does not impede or delay the secured lender's ability to exercise remedies against the loan collateral, and does not subject the loan collateral to potentially competing claims that could be heard in a bankruptcy proceeding.

In federal, state and bankruptcy courts across the country, lenders and borrowers and guarantors have been fighting over the enforceability of these instruments. Lenders have sought to get the benefit of the bargain they struck with the guaranties—that if the borrowers voluntarily filed or colluded in an involuntary bankruptcy filing, they would be liable for the full loan amount—and borrowers have sought to declare the guaranties unenforceable on procedural grounds, public policy grounds, and more traditional legal grounds of bad faith, unconscionability, anti-forfeiture, and similar bases.

Court Rulings

In the most recent New York decision to come down on the subject, *UBS v. Garrison Special Opportunities Fund,* (Sup. Ct. NY County, Index No. 652412/2010), the court considered a range of procedural and substantive defenses raised by the guarantor and ordered—as have many other state and federal courts—summary judgment in favor of the lenders on the guaranty.

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A survey of the decisions on the topic shows that while guarantors have often raised compelling defenses to liability, lenders have nearly always prevailed in enforcement of the guaranties, at least in the situations which have been litigated to judgment. In so observing, we note that most jurisprudence in this area does not deal with the more difficult or unusual cases of the type we discuss in more detail below, possibly because the stakes are high enough that these difficult cases are settled out of court.

In federal, state and bankruptcy courts across the country, lenders and borrowers and guarantors have been fighting over the enforceability of these instruments.

In the ordinary course, courts have tended to view the plain language of the guaranties, the strength of the waivers and the sophisticated nature of the parties negotiating and giving the guaranties, as a solid legal basis to enforce the provisions of the guaranties as written. When faced with arguments from guarantors that the enforcement of a bankruptcy springing recourse guaranty is against public policy favoring bankruptcy as a means of restructuring debt, or creates a forfeiture out of proportion to the harm suffered by the secured lender, the courts have generally declined to substitute the judgment of the court for that of the parties as to the proper alignment of power in a real estate negotiation.

On the procedural level, courts have upheld the granting of summary judgment under CPLR 3213 for the enforcement of bankruptcy springing recourse guaranties, finding them to be simple "instruments for the payment of a money only" and not more complex guaranties of performance.[1]

On the substantive level, courts have held that bankruptcy springing recourse guaranties:

• Are not void as "ipso facto" clauses under the bankruptcy code, but are rather a legitimate and permissible mode of bankruptcy-remote structuring.[2]

• Are not void as in terrorem clauses, but create an important deterrent effect to the behavior sanctioned.

• Do not constitute a penalty, or unenforceable liquidated damages, but represent an agreement to pay a valid debt of a sum certain.[3]

• Do not induce breach of fiduciary duty or set up a conflict of interest for directors, whose duties are to the company and its shareholders and creditors, and not to the guarantor.[4]

• Are not void on public policy grounds favoring bankruptcy, because the real estate financial markets, consisting of powerful and sophisticated business interests, created another paradigm for dealing with lending risk and remedies that was designed to avoid bankruptcy courts.[5]

Conflicts Among Lenders

What none of the court rulings really confront, however, is the power dynamic among lenders with which every real estate practitioner trying to negotiate a resolution of a troubled loan has had to contend. That is, in complex, multi-layered loan structures, with multiple lenders at different levels of the capital stack and within a single tranche, the biggest impediment to the lenders' objective of being able to preserve and realize upon the value of the real estate collateral is often not the obstructive actions of the borrower, but conflicts and disputes within and among the lender groups themselves. In those situations, a guarantor with a broadly-written bankruptcy springing recourse guaranty can be put at enormous risk, because conflicts among lenders can make it difficult for a borrower to come to a swift resolution of a loan default situation with the lenders, even with the best of borrower intentions.

Consider, for example, the following scenario: a defaulted borrower attempts to tender a deed and/or assignment of partnership interests in lieu of foreclosure to the senior and/or mezzanine lenders. The lenders dispute which group has the right to take the deed and/or assignment, the conditions under which a deed will be accepted, and what responsibilities the group taking the deed and/or assignment has to the other lenders, such as obligations to cure senior loan defaults, put up a replacement guarantor, etc.

While those disputes are pending, no lender is able to take a deed, and the property may be left in the operation of the borrower. The borrower may not have funds to operate the property, where cash is held in a lockbox and applied to the debt in accordance with the loan documents, and where the lenders may be deadlocked about releasing cash for operations. If the borrower has no working capital to operate the property, the property may quickly lose value.

A situation of this type is especially acute in the case of hotel assets, which, more than other types of real estate assets, are operating businesses with recurring daily operating costs. The borrower in that situation may determine that the only action it can initiate to preserve the value of the collateral for the benefit of the lenders is to file for bankruptcy to obtain a cash collateral order permitting the operations of the property, in an instance where a lender has not sought appointment of a receiver. The directors of the borrower, including the independent directors, may determine that their fiduciary obligations to the borrower and to the borrower's creditors in an insolvency context are to file for bankruptcy.

That scenario approximates the set of circumstances described in court papers filed by the borrower in the lawsuit *Bank of America, et al. v. Lightstone Holdings LLC and David Lichtenstein*, Index No. 601853/2009, and related cases, currently pending in Supreme Court, New York County, in which multiple lenders are suing the guarantor under the bankruptcy springing recourse guaranty following the conclusion of the Extended Stay Hotels bankruptcy case, *In re Extended Stay Hotels LLC*, No. 09-13764 JMP (Bankr. S.D.N.Y.).

Without commenting on the particular legal or factual allegations in the *Lightstone* case, the argument nevertheless illustrates a potential quagmire in which a borrower can inadvertently find itself: the borrower, having allegedly attempted unsuccessfully to tender a deed or assignment in lieu of foreclosure to the lenders, is forced to choose between filing bankruptcy to preserve the operations of the real estate and avoiding "waste" of the loan collateral, or shutting down property operations and potentially diminishing collateral value for the lenders. The guarantor argues that he would potentially face recourse liability either way—if the borrower filed bankruptcy or if the borrower committed "waste" of the collateral.

Here, the directors of the borrower determined that their fiduciary duty required them to choose bankruptcy as the option best designed to preserve collateral value for the benefit of the lenders. The guarantor thus finds itself in a conundrum. It has attempted to tender a deed to resolve a default situation—a result that the bankruptcy springing recourse guaranty is ostensibly designed to promote—but conflicts among the lenders have resulted in the inability or unwillingness of the lenders to take the deed that is offered, leaving the borrower in a position where a bankruptcy filing may be the only action a borrower can take to preserve collateral for the lenders.

Consider next another not uncommon situation, where a mezzanine lender exercises control over a borrower through taking over the upper-tier ownership interests and/or management of the borrower, with the objective of filing a voluntary bankruptcy of the borrower. In a situation where the guarantor has not been exculpated from the acts of the mezzanine lender through an express exception written into the guaranty, the guarantor is potentially at risk of full recourse arising from the bankruptcy filing by the mezzanine lender over which the guarantor has no control.

Such a filing may have a legitimate business purpose for the mezzanine lender, by preserving its collateral from mortgage foreclosure, to the detriment of the senior lender. But the sheer magnitude of the potential loss to the guarantor can also give a mezzanine lender whose loan is underwater and who has no remaining economic stake in reorganizing the collateral, enormous leverage to extract a payout from a guarantor to avoid triggering the guarantor's liability. Certainly, few would argue that lender and borrower intended to create recourse liability of this type for the acts of a party over which the guarantor has no control.

While the mezzanine lender which caused the liability would likely have a hard time enforcing a springing recourse guaranty running for its own benefit under well-established principles that a court will not allow a party to the benefit of a remedy from a default it caused, it is not clear that existing case law would not protect the guarantor from liability under parallel guaranties made to the other non-foreclosing lenders in the capital stack.

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Consider further, a situation where a syndicate of lenders is unable to resolve a default with a borrower consensually, because of the requirement to obtain unanimity or near-unanimity among a group of lenders, where the group contains a holdout who is seeking a buy-out of its loan position. In that instance, the majority lenders may themselves wish to utilize bankruptcy to restructure the debt, and use a cram-down to deal with the recalcitrant lender. But the majority lenders may not be in a position to protect the guarantor in a bankruptcy filing, even though a filing is desired by both the borrower and the majority lenders because it provides a judicial mechanism to force settlement of the matter.

The common thread in each of the above scenarios is that conflicts among lenders which create an inability to resolve a loan default, rather than a borrower's desire to impede a lender's remedies, may be the motive force leading to a bankruptcy filing. The situation can be coercive, as in the case of the mezzanine foreclosure, or voluntary, as a fiduciary act by the directors of the borrower in the case of an inability to tender a deed in lieu or settle a consensual workout. But in each case, it is clear that the guarantor is the party at risk, in a situation which bears little relationship to the actions the bankruptcy springing recourse guaranty was designed to protect against—that is, a borrower willfully impeding a secured lender's ready access to the loan collateral.

In each of these situations, enforcement of a bankruptcy springing recourse guaranty creates injustice, inefficiency in workouts, unduly strengthens the bargaining power of minority interests or interests which are out of the money, and puts directors in a position of conflict between their fiduciary duty to the borrower and its shareholders and creditors, and creating potentially ruinous personal liability to a guarantor, who is often the director.

Drafting Exceptions

If courts are reluctant to take it upon themselves to rewrite the express language of the bankruptcy springing recourse guaranty but will insist on enforcing the guaranties as written, then the compelling arguments raised by borrowers and guarantors must find their way into the drafting of specific exceptions into a new era of guaranties.

Among the exceptions to consider including in a new "standard" form of bankruptcy springing recourse guaranty are exculpation of the guarantor where: (i) the borrower has made a good faith effort to tender title and/or membership interests in lieu of foreclosure, but the tender could not be effectuated and bankruptcy is necessary to avoid waste of the collateral; (ii) a mezzanine lender acts for the borrower after the mezzanine lender has taken ownership and/or control of borrower; (iii) the borrower's directors are advised by outside counsel that filing is required by of the fiduciary obligations of the directors, acting in the interests of the borrower company and its creditors in an insolvency situation, and/or (iv) a majority of lenders in a syndicated group or among an intercreditor arrangement requests or consents to the borrower filing.

1. See UBS, supra.; citing *Bank of America, N.A. v. Solow*, 2008 WL 1821877 (NY Sup Ct), aff'd 59 AD3d 305 (1st Dept. 2009).

2. See *First Nationwide Bank v. Brookhaven Realty Assoc.*, 223 A.D. 2d 618 (NY App. Div. 2d Dept. 1996), finding that a bankruptcy full recourse guaranty was enforceable as written, even if no damages as result thereof; *Bank of America, N.A. v. Lightstone Holdings, LLC and Lichtenstein Bank*, no. 09-01353 (SDNY 2009), finding that it is legitimate to do bankruptcy-remote structuring.

3. See *CSFB 2001-CP-4 Princeton Park Corporate Center, LLC v. SB Rental I, LLC*, 410 N.J. Super. 114 (NJ Super. 2009), upholding full guarantor recourse (in a non-bankruptcy carve-out situation) on the grounds that that repayment of debt is actual damages, not liquidated damages, and carve-out just set terms of liability rather than setting measure of damages.

4. See *UBS*, supra., finding that there is "no distinction between this set of facts and those involving any parent corporate guaranty of a debt of a subsidiary," and that such guaranties are a "common commercial arrangement not subject to question."

5. See *FDIC v. Prince George Corp.*, 58 F.3d 1041 (4th Cir. 1995), finding that a carve-out guaranty did not prevent borrower from filing, but guarantor would merely forfeit its exemption from liability for any deficiency.