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Financial Covenants In Non-Recourse Carveout Guaranties

BY MITCHELL L. BERG,
PETER E. FISCH
AND MANUEL E. LAUREDO

Since the credit crisis of 2008, much has been written about the expanding scope of non-recourse carveout guaranties in commercial real estate loans and the manner in which they have been interpreted and enforced. What began as a mechanism for deterring wrongful acts by the project sponsorship (e.g., fraud and misappropriation) and obstacles to the enforcement of the lender's remedies (e.g., voluntary or collusive bankruptcy actions and assertion of bad faith defenses) has, on occasion, evolved into a means of shifting economic risk to the guarantor for circumstances that may not be within the guarantor's control (e.g., failure to pay operating expenses and other consequences of a project's poor performance) and for which the guarantor sought the protection of non-recourse financing in the first place.

So far, courts have generally sided with lenders in litigation that challenges the enforceability of these guaranties by, among other things, rejecting equitable arguments asserting that non-recourse carveout guaranties result in unenforceable penalties or should otherwise be voided on public policy grounds, and instead favoring a plain reading of unambiguous provisions negotiated by sophisticated parties.¹ In some instances, courts have imposed full recourse under non-recourse carveout guaranties even where there was little or no actual damage suffered by the lender as a result of the proscribed carveout event.

Against this backdrop of expansion and judicial reaffirmation, lenders are increasingly

scrutinizing the creditworthiness of non-recourse carveout guarantors, insisting in many cases that they agree to comply with continuing financial covenants during the terms of their loans. This is a significant change, considering that not long ago conduit lenders would frequently accept non-recourse carveout guaranties from special purpose vehicles having no assets other than their indirect interests in the mortgaged property. Conduit lenders are now requiring as an initial condition to funding that guarantors have meaningful net worth independent of the mortgaged property, together with ongoing net worth and liquidity covenants.² As is the case with negotiating the scope of the carveouts themselves, special attention should be paid to the drafting of net worth and liquidity provisions in non-recourse carveout guaranties to ensure that each party's objectives are achieved.

Net Worth Covenants

The most common ongoing financial covenant appearing in non-recourse carveout guaranties is the obligation of the guarantor to maintain a minimum net worth until the debt is repaid and/or all guaranteed obligations have been satisfied. Aside from agreeing on the minimum dollar amount—which in the authors' experience can vary considerably in relation to the amount of the underlying indebtedness—a critical issue for the guarantor and the lender is which assets and liabilities should be included, excluded or deducted in determining "net worth." Often, the guaranty provides little guidance in this regard, setting forth a simple definition of net worth as the excess of the value of the guarantor's assets over its liabilities, each as determined in accordance with generally accepted accounting principles (GAAP) or another financial accounting method. From the lender's perspective, a more detailed provision crafted with the goal of increasing its recovery under the guaranty would seek to narrow the universe of qualifying

"assets" and expand the universe of potential "liabilities" used to calculate net worth beyond relying on what is reportable in accordance with an accounting methodology.

On the asset side, a lender may want to exclude the value of the guarantor's direct or indirect interests in the mortgaged property, since the primary objective of the test as noted above is to verify creditworthiness independent of collateral already pledged to the lender and given the likelihood that the pledged collateral may have little or no value under the circumstances where a guaranty claim is being asserted. In addition, a lender may ask to exclude intangible assets of the guarantor, such as goodwill, franchises, licenses, trade names and deferred and prepaid expenses, which would otherwise be included in a guarantor's balance sheet prepared in accordance with GAAP.

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On the liability side, a lender may seek to capture guaranty, letter of credit, hedge contract and other contingent liabilities to the extent the same would not be reflected on the guarantor's balance sheet in accordance with GAAP, up to the maximum liquidated sum payable thereunder (or some other amount reasonably determined by the lender).

Conversely, the guarantor should seek to broaden the scope of assets and narrow the scope of liabilities included in the calculation

MITCHELL L. BERG and PETER E. FISCH are partners at Paul, Weiss, Rifkind, Wharton & Garrison. MANUEL E. LAUREDO is a counsel at the firm.

of net worth to better insulate itself against a breach which may result in an event of default and an acceleration of the loan. As discussed in more detail below, investment funds, real estate operating companies and other similar types of guarantors should seek to include as part of their asset base (for net worth and also for liquidity purposes) unfunded capital commitments from their investors and sums that may be drawn on subscription or other lines of credit, as well as cash held by subsidiaries of the guarantors and available for distribution. Guarantors (and on occasion lenders) likely want assets valued on a fair market basis as opposed to a book basis, so the parties need to be clear in drafting the net worth provisions to avoid unintended results that may result from GAAP accounting.

On the other side of the ledger, the guarantor should make clear that liabilities associated with the mortgaged property should be excluded from the calculation of net worth to the extent that the value of the mortgaged property is not counted as one of its assets. Moreover, the guarantor should insist, to the extent contingent liabilities are included in the net worth calculation, that the same should not include its obligations under customary environmental indemnities and non-recourse carveout guaranties delivered in connection with other loans until the occurrence of an event that causes its obligations to become a current liability in a liquidated sum (e.g., the entry of a judgment the amount of which is subject to such guaranty or indemnity, or the triggering of full or partial recourse upon a bankruptcy filing).

Looking beyond the mechanics of calculating net worth, the guarantor should be thoughtful about ways to mitigate its risk of triggering defaults as a result of events not within the guarantor's control that may negatively impact net worth. The most obvious way is for the guarantor to ask for notice and the right to cure a breach of the net worth covenant before the breach ripens into an event of default under the loan documents, either by substituting or supplementing the original guarantor with another guarantor having the requisite net worth on its own or in the aggregate with the original guarantor (although lenders often will impose limits on the number of guarantors they will need to pursue in the event of a guaranty claim), or by offering alternative collateral. In some instances, a lender may also agree to reduce the required dollar amount of independent net worth upon the property achieving a greater level of profitability, as measured by an increased debt yield ratio or debt service coverage ratio.

Still another approach a guarantor can take to manage its risk is to try to eliminate the net worth maintenance covenant altogether in favor of a covenant not to consummate affiliate or otherwise non-arm's length transactions, and/or sell, transfer, pledge or otherwise encumber its assets and distribute the proceeds, if the same would cause the guarantor to breach the required

minimum net worth threshold (unless the guarantor can substitute or supplement its credit or offer additional collateral to bridge the gap as a condition to consummating any such transfer or encumbrance).³ This last alternative is preferable from the guarantor's perspective because it limits breaches of the net worth covenant to affirmative actions within the guarantor's control rather than reductions in net worth that might occur as a result of market cycles or unforeseen economic events.

Liquidity Covenants

In addition to net worth requirements, lenders are increasingly requiring guarantors to maintain a minimum level of liquidity in connection with non-recourse carveout guaranties. Liquid assets are typically defined to include cash and cash equivalents, obligations of the U.S. government supported by its full faith and credit, certificates of deposit issued by commercial banks having net assets of not less than a specified threshold amount, securities listed and traded on a recognized stock exchange or traded over the counter and listed in the National Association of Securities Dealers Automatic Quotations and liquid debt instruments that have a readily ascertainable value and are regularly traded in a recognized financial market. Lenders sometimes (but not always) further specify that such liquid assets must not be pledged, encumbered or otherwise restricted in use, including by operation of any applicable cash management system.

Lenders and guarantors are well advised to exercise care in negotiating the financial covenants applicable to the guarantor during the term of the loan.

A guarantor having limited liquidity should request that the lender allow it to count other less obvious sources of cash in order to satisfy the minimum threshold, including, as noted above, (a) cash held by a guarantor's subsidiaries that are controlled by the guarantor and available for distribution to the guarantor, (b) amounts drawable on revolving lines of credit and subscription facilities from institutions having pre-approved credit ratings, and (c) unfunded cash commitments from creditworthy investors of investment fund guarantors, including amounts that may have previously been distributed to such investors and that are recallable in accordance with the guarantor's governing documents. In evaluating these requests, lenders should exercise caution to ensure that only unrestricted and otherwise readily available amounts are counted as liquid assets.

In the case of unfunded cash commitments to investment fund guarantors, this may involve

(i) confirming through diligence that there are no unsatisfied conditions to the funding of such commitments (other than the giving of notice or other administrative requirements), (ii) deducting any indebtedness secured by such commitments from the calculation of liquid assets, and/or (iii) excluding capital commitments from investors that are in default in their obligation to make capital contributions to the guarantor beyond applicable notice and cure periods (or have otherwise been repudiated), or are subject to a bankruptcy proceeding. In addition to the foregoing, lenders may cap the amount of commitments that may be counted to satisfy the liquidity threshold to ensure there is a minimum amount of immediately available liquidity.

Conclusion

Although by no means a universal requirement, especially in the case of "warm body" guarantors, financial covenants in non-recourse carveout guaranties are on the rise. Lenders and guarantors are well advised to exercise care in negotiating the financial covenants applicable to the guarantor during the term of the loan. Both sides should concern themselves with the scope of assets and liabilities that are counted for purposes of the tests. The guarantor should also insist upon notice and cure rights, including the right to replace or supplement itself as a surety and/or provide alternative collateral to head off a potential event of default. The guarantor should also try to eliminate strict maintenance requirements in favor of covenants against divesting or encumbering assets below the required thresholds to protect against diminution in value as a result of circumstances not within its control. Lenders should take care to include regular reporting and officer certifications as part of the financial covenants to ensure they stay ahead of any issues that may compromise the value of their non-recourse carveout guaranties.

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1. See also New York Law Journal, Feb. 15, 2012, "Negotiating Non-Recourse Carveout Guaranties" by Mitchell L. Berg and Peter E. Fisch.

2. One reason for this trend may be the expansion of representations and warranties required from sellers of commercial mortgages bound for securitization in response to The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The Model Representations and Warranties released by the Commercial Real Estate Finance Council in March 2011 require, in pertinent part, that the seller represent that the mortgage loan documents provide for full or partial recourse, as applicable, to a guarantor that is a natural person or persons, or an entity distinct from the mortgagor (but that may be affiliated with the mortgagor) that has assets other than equity in the related mortgaged property that are not de minimis. Note that lenders typically will show more flexibility in these requirements for "warm body" individual guarantors.

3. It's not uncommon for lenders to include a prohibition on the non-recourse carveout guarantor selling or encumbering its assets if the same would result in reducing the guarantor's net worth below the specified threshold in addition to a general maintenance covenant, although the additional covenant is usually limited to any period during which a default in the payment of the guaranteed obligations exists.