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REAL ESTATE FINANCING

# Releases of Liability Under Loan Guaranties

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In general, commercial real estate loans are non-recourse in nature and the lenders ultimately look to their collateral for the satisfaction of the borrowers' obligations if the loan goes into default.

However, lenders typically require guaranties and other credit support from creditworthy individuals or entities, making the guarantors personally liable for certain obligations.

The five types of guaranties most commonly required in connection with commercial real estate loans are: (i) non-recourse carveout (or "bad-boy") guaranties, (ii) environmental indemnities, (iii) repayment guaranties, (iv) carry guaranties and (v) completion guaranties.

When and how the guarantor is released from liability under each of these guaranties is a key point of negotiation between lenders and borrowers/guarantors and has implications for other lenders and investors with interests in the collateral.

## Non-Recourse Carveout Guaranties

A non-recourse carveout guaranty, which is required for almost any commercial real estate loan, makes the guarantor liable for specified acts or omissions of the borrower that, generally speaking, pose a risk of degrading the lender's collateral (and therefore are excepted from the lender's agreement to limit recourse to that collateral).

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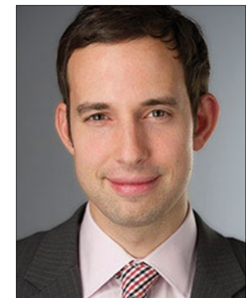

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Typically, a non-recourse carveout guaranty will bifurcate such acts or omissions into (i) those that trigger "full recourse" to the guarantor for the entire outstanding amount of the loan (such as unauthorized transfers and voluntary or collusive bankruptcy filings) without the lender having to prove its damages and (ii) those that trigger "limited recourse" to the guarantor only for losses incurred by the lender as a result of the applicable acts or omissions (such as physical waste and misapplication of funds constituting collateral for the loan).

Once the loan is repaid in full, a non-recourse carveout guaranty has in effect been fully performed,

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but it is important for a guarantor to obtain an earlier release under certain circumstances.

A guarantor should be released from liability under a non-recourse carveout guaranty on a prospective basis upon the completion of a foreclosure or the acceptance of a deed in lieu of foreclosure by the lender with respect to the encumbered property (in some cases liability may also cease upon the appointment of a receiver for the property).

Even after a foreclosure or the acceptance by the lender of a deed-in-lieu, a guarantor may remain liable for losses that relate to facts and circumstances (known or unknown) in existence on or prior to the date of such foreclosure or acceptance of a deed-in-lieu.

Where a mezzanine financing is also in place, it is important for the guarantor to also obtain a release for any liabilities accruing under the mortgage guaranty from and after a mezzanine foreclosure, since the guarantor will no longer control the actions of the mortgage borrower.

### Environmental Indemnities

An environmental indemnity protects the lender against liabilities and losses arising from environmental conditions at the encumbered property. A lender may be liable for environmental conditions at the property if (for example) it participates or is deemed to have participated in the management of the property, and the presence of environmental conditions may impair a lender's ability to recover the outstanding debt through foreclosure.

A borrower's repayment of the indebtedness or a lender's foreclosure or acquisition of the property is not generally sufficient to release the borrower's and guarantor's obligations to indemnify the lender in connection with environmental conditions.

Lenders will often agree to a sunset provision to provide a temporal limitation on the guarantor's liability, whereby the guarantor will be released after a specified period of time (often between one and three years) following the repayment or transfer date, subject to agreed conditions—typical conditions would be delivery of a current and clean environmental report and that no environmental claim be outstanding at the time of the release.

Because the indemnitors' liability generally continues after a foreclosure is completed or a deed-in-lieu is accepted (and the borrower ceases to own and control the property), environmental indemnities often provide that the indemnitors are not responsible for liabilities and losses resulting solely from events first occurring or conditions first existing after the date of the foreclosure or deed-in-lieu (or, where a mezzanine loan is also present, after the mezzanine lender takes over the borrower).

One additional strategy for the indemnitors to limit liability under an environmental indemnity is to procure and maintain an environmental insurance policy and to negotiate a provision in the indemnity requiring the lender to look to the policy before making a claim under the environmental indemnity.

Typically, the lender will only be required to pursue payment under such policy for a specified period of time (often between sixty and one hundred eighty days) prior to exercising its rights under the environmental indemnity. If the lender is able to collect any insurance proceeds, the guarantor remains liable for any deductible and for any losses in excess of the proceeds.

When and how the guarantor is released from liability under each of these guaranties is a key point of negotiation between lenders and borrowers/guarantors and has implications for other lenders and investors with interests in the collateral.

### Repayment Guaranties

In certain situations, particularly for construction loans and other loans for assets that are not stabilized, a lender may require a guaranty of all or a specified portion of the indebtedness. Since a repayment guaranty is intended to protect the lender against loss following the exercise of its other remedies, a foreclosure or the acceptance of a deed-in-lieu will not release the guarantor from liability, and in fact will be the event that determines the lender's loss.

The obligations under a repayment guaranty continue until the loan has been repaid in full or the guaranteed amount is fully paid.

Many repayment guarantees provide for a reduction or "burning off" of the guaranteed amount, or a release from the guaranty altogether, upon the property and/or borrower achieving specified thresholds (such as an agreed-upon debt service coverage ratio). The rationale from the lender's perspective is that the need for a repayment guaranty diminishes as cash flow from the encumbered property improves.

In the event that there is more than one guarantor providing a repayment guaranty in connection with the same loan, the lender will often agree to several (rather than joint and several) liability for each guarantor. This further reduces the maximum liability of each individual guarantor.

### Completion Guaranties

A construction lender or a lender making a loan secured by a property that is undergoing (or is expected to undergo during the loan term) substantial capital improvements typically requires a completion guaranty—i.e., a guaranty of completion of the contemplated construction project by a negotiated outside date, free and clear of liens, and substantially in accordance with plans that have been approved by the lender.

If the borrower fails to complete the project by the outside date, the lender typically has one or more of the following remedies: (i) to complete the project itself at the guarantor's expense, (ii) to require the guarantor to complete the project (using any remaining loan proceeds as well as its own funds), or (iii) to collect liquidated damages from the guarantor without actually having to complete the project.

In all cases, the guarantor's liability is limited to the amount required (or, in the case of liquidated damages, the amount that would have been required) to complete the project in accordance with the approved plans, less any undisbursed loan amounts (including any construction or "loan balancing" reserves held by the lender).

If the lender elects to complete the construction itself, the guarantor is generally responsible for cost overruns only to the extent incurred to complete the project in accordance with the approved plans (and not as a result of changes made by the lender that increase the cost of construction), although lenders sometimes retain flexibility to make certain modifications.

If the lender elects to have the guarantor complete the construction, the guarantor will want to maximize its ability to draw on the unfunded portion of the construction loan by limiting the conditions to such draws.

As noted above, subordinate financing (such as a mezzanine loan or preferred equity) adds another wrinkle for lenders and guarantors to consider.

A completion guaranty is generally released when the project has been completed and the statutory period for the filing of mechanics' or materialmen's liens in connection with such construction has expired.

While the liquidated damages remedy is often only available to the lender, in some cases a borrower can negotiate the right to tender the property and pay the liquidated damages amount to satisfy its obligations under the guaranty. A completion guaranty is also released upon payment in full of the indebtedness.

### Carry Guaranties

A carry guaranty is often required where the property securing the loan is under construction or is otherwise not generating sufficient cash flow to pay the costs of operating and maintaining the property. It obligates the guarantor to pay operating and maintenance costs, such as insurance premiums, utility charges and real estate taxes, for the property, for an interim period while property cash flow is insufficient to pay those costs.

A guarantor will be released from its obligations under a carry guaranty upon the full repayment of indebtedness. In addition, a carry guaranty usually provides for release once the encumbered property reaches a stipulated level of financial performance (like meeting a debt service coverage or debt yield test).

Generally, carry guaranties also provide for release of the guarantor upon a foreclosure, the acceptance by the lender of a deed-in-lieu, or the tender by the borrower of a deed-in-lieu that the lender does not accept, although they sometimes provide for a "tail"—i.e., a period of time (ranging from thirty days to one year) after a foreclosure, deed-in-lieu or tender—during which the guarantor remains liable under the guaranty.

Regardless of whether a "tail" applies, a release of the guarantor in connection with the lender's acceptance or the borrower's tender of a deed-in-lieu is often subject to the satisfaction of a number of specified "tender conditions," which may include, for example, the delivery of a current and clean environmental report, good title to the property, title insurance, transfers of personal property related to the property, a release of the lender, and payment of any amounts then owed by the guarantor under its other guaranties in respect of the loan.

## Other Considerations

Loan documents often provide for the release of existing guarantors upon the delivery of new guaranties from acceptable replacement guarantors. These provisions are important to guarantors in the event of a permitted transfer of the property or the borrower (including a permitted transfer of control between joint venture partners) or where the initial guarantor is not capable of satisfying financial covenants under the guaranty.

In many cases, the standards for acceptable replacement guarantors (e.g., specific net worth and liquidity requirements) are set forth in the loan documents so that the acceptance of a replacement guarantor is not left completely to the discretion of the lender.

If the borrower is a joint venture and one or more of its members (or principals or affiliates thereof) deliver guaranties in respect of loans to the joint venture, the members frequently negotiate among themselves different indemnities and protections to reduce each guarantor's exposure in advance (or in the absence) of an actual release of such guarantor's obligations.

Often, each member providing a guaranty is entitled to receive contribution or indemnification from the other members.

In addition, if one member of a joint venture manages the development of a project or the operation of a property, delivers any guaranties in connection with financing for the project or property, and is subsequently removed as the manager (such that it is no longer able to avoid or mitigate liability under the guaranties), the joint venture documents will customarily require the other members to provide a substitute guarantor and use commercially reasonable efforts to obtain a release of the guaranties.

If the other members are unable to obtain the release, they are usually required to provide a creditworthy affiliate to indemnify the guarantor for any further liabilities under the guaranties.

As noted above, subordinate financing (such as a mezzanine loan or preferred equity) adds another wrinkle for lenders and guarantors to consider. Guaranties given to both the senior lender and the junior lender should provide that an exercise of remedies by either lender will not trigger liability under any of the guaranties.

The guarantor will also want to ensure that the guarantor will not incur liability under the guaranties for any losses resulting from the actions of the junior lender after the exercise of an equity foreclosure, a takeover, or an exercise of voting or control rights by the junior lender.

Often, a guarantor will be released from obligations under certain applicable guaranties, as noted above, that arise after a foreclosure (or the acceptance of a deed or assignment in lieu of foreclosure) by either lender.

It is common practice in intercreditor agreements between mortgage lenders and mezzanine lenders that a mezzanine lender is not permitted to acquire its equity collateral unless and until it provides replacement guaranties (especially to the extent the initial guarantor is released under the corresponding guaranties).

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