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Phone: +1 212 537 6331 | Fax: +1 212 537 6371 | customerservice@portfoliomedia.com

Springing Guaranty Risks In The Current Economy

Law360, New York (February 05, 2009) -- Although the credit crisis had its start with the single-family “subprime” residential loan industry, the contagion has now spread to commercial real estate loans.

This is true not only because of the limited available credit to refinance maturing loans, especially loans that were originally financed by conduit lenders, but also because commercial real estate vacancy rates are rising rapidly and values of properties are dropping.

With job cuts rampant and businesses either failing or retrenching, the immediate prospects for a turnaround are poor and the Urban Land Institute has warned that 2009 will be the worst year for the commercial real estate market since the recession of 1991-1992.

Commercial real estate owners, their constituent stakeholders and their lenders face unprecedented challenges today — challenges that seemed unimaginable only one year ago.

Many own, manage or hold mortgages on, or equity interests in, assets that are either non-performing or approaching failure. Others are already at the point where they must decide whether to hold on to, bail out of or take over projects that just recently seemed destined for success.

These challenges are due not only to the limited availability of viable refinancing or recapitalization options given today’s liquidity lock up, but also due to the new debt and equity underwriting standards and associated return requirements.

These difficult circumstances for the real estate industry are exacerbated by the absence of any meaningful benchmarks for asset valuations and the declining operational project cash flow resulting from current recessionary conditions.

Borrowers with existing CMBS conduit financing, and to a lesser extent borrowers with commercial bank, Freddie Mac or Fannie Mae loans, will face significant hurdles as their loans mature.

Both regular and special servicers of conduit debt have limited ability to engage in workout negotiations and no ability to extend new credit.

Traditional sources of financing such as commercial banks and insurance companies may or may not offer realistic alternatives and many borrowers will need to engage in loan restructurings, where possible, and will need to consider filing bankruptcy petitions where workouts are either unavailable or unsuccessful or will need to be prepared to surrender their properties to their lenders.

As they proceed through these workout processes, borrowers should carefully evaluate the risk of taking actions that will trigger liability on springing guaranties that were required as part of substantially all conduit loans, as well as many non-conduit loans.

Springing guaranties routinely contain provisions that will render guarantors, which are typically upstream creditworthy owners, fully liable for the debt where the borrower, any of the upstream owner entities or individuals, and in some instances any affiliates, file a voluntary bankruptcy petition, consent to an involuntary petition or fail to contest or collude in the filing of an involuntary petition, since such actions will impede the lender's ability to take control of or foreclose on its collateral.

Conduit lenders in particular routinely included loan provisions to deter borrowers and upstream owners from filing bankruptcy actions that would either prevent the lenders from exercising their foreclosure and other remedies under the loan documents or that could impair the lenders' enforcement rights by serving as a basis to substantively consolidate the assets and liabilities of the borrower with those of its affiliates or owners.

Although lenders' requirements vary widely, conduit loans typically contain the most extensive requirements that can trigger either full guarantor liability for the entire outstanding principal amount and other sums due under the loan or liability for damages that result from certain actions.

The following is a non-exhaustive list of typical actions that can trigger at least partial guarantor liability on at least some conduit loans:

- The borrower, an affiliate of the borrower or a guarantor files a voluntary bankruptcy petition or the borrower colludes in the filing of an involuntary filing;
- The borrower engages in any business unrelated to the acquisition, development, ownership, management, leasing or operation of the mortgaged property or the borrower has assets that are unrelated to the mortgaged property;

- The borrower engages in or consents to a dissolution, liquidation or winding up of its business;
- The borrower commingles its funds or assets with those of any other entity except where permitted by the loan documents to participate in a cash management system;
- The borrower fails to conduct its business in its own name; or
- The borrower makes loans to any affiliates.

Courts have evaluated the enforceability of springing guaranty provisions in only a handful of reported decisions and we can expect that the enforceability of these provisions will be hotly contested over the next several years.

At least initially lenders appear to have the advantage with several courts enforcing springing guaranties. See, *FDIC v. Prince George Corp.*, 58 F.3d 1041 (4th Cir. 1995); *Blue Hills Office Park LLC v. J.P. Morgan Chase Bank*, 477 F.Supp. 2d 366 (D. Mass. 2007); *First Nationwide Bank v. Brookhaven Realty Associates*, 637 N.Y.S. 2d 418, 223 A.2d 618 (N.Y. App. 1996).

Not to be deterred, borrowers and guarantors will surely attack springing guaranties on a variety of grounds.

Borrowers that file for bankruptcy may seek injunctions under section 105 of the Bankruptcy Code (which grants courts the power to “issue any order, process or judgment that is necessary or appropriate to carry out the provisions of this title”) to prevent lenders from proceeding against guarantors.

They may also contend that a lender’s action on a springing guaranty constitutes an unreasonable penalty under section 506(b) of the Bankruptcy Code.

Borrowers which have breached the loan covenants and already triggered the obligations on springing guaranties may not face any downside on filing for bankruptcy. However, borrowers which have complied with the covenants will have to consider carefully whether it’s worth filing bankruptcy petitions and risking exposing the guarantors to liability to try to save their properties.

--By Jeffrey L. Tarkenton, Womble Carlyle Sandridge & Rice PLLC

Jeffrey Tarkenton is a member of Womble Carlyle and practices in the firm’s Washington, D.C., office.

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