

# Recent Cases Concerning “Springing” or “Bad-Boy” Guaranties—Are They Enforceable?

by

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## **Introduction**

Bankruptcy courts generally do not enforce agreements by borrowers to waive their right to file bankruptcy, as a matter of public policy. *See, e.g., Klingman v. Levinson*, 831 F.2d 1292, 1296 n.3 (7<sup>th</sup> Cir. 1987). Over the years, lenders have devised ways around this absolute principle by obtaining borrowers’ agreement in advance to waive certain specific protections offered under the Bankruptcy Code, such as the automatic stay, for example. Some lenders obtain borrowers’ advance stipulation to the existence of certain facts that would be considered by the courts as indicative of bad faith. These more limited and less direct waivers of bankruptcy protection have met with mixed success in the bankruptcy courts.

More recently, lenders have included in their loan documents language that does not require the borrower to waive a specific right under the Bankruptcy Code, since those provisions have met with limited success, but rather discourages the borrower from filing for bankruptcy protection in the first instance. These

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bankruptcy disincentives include mechanisms such as “springing” and “exploding” guaranties, clawback provisions, and single-purpose entity structures. The prevalence of collateralized mortgage-backed securities (“CMBS”) loans in the last decade, coupled with the current prolonged downturn in the commercial real estate market, has resulted in increased litigation over the validity and extent of such devices. This summary will discuss a number of recently decided cases, primarily on springing, or “bad boy” guaranties.

### **“Springing” or “Bad Boy” Guaranties**

Over the years, commercial real estate lenders have increasingly become focused on asset-based lending rather than on loans based upon income streams. Under an asset-based approach to lending, a lender requires that its collateral be isolated in a “single-purpose” entity so that it is not affected by other collateral or financial issues of the borrower. *See, e.g., Wells Fargo Bank N.A. v. Cherryland Mall L.P.*, 295 Mich. App. 99, 812 N.W.2d 799 (2011). Although such loans are typically non-recourse, they are supported by a “bad boy” guarantee that springs into effect on the occurrence of a particular event, such as filing for bankruptcy protection or affecting the “bankruptcy remote” aspects of the single-purpose entity.

Such carve-outs vary widely from loan to loan. In addition to filing a voluntary bankruptcy, or destroying the “bankruptcy remote” nature of the single-purpose entity, triggers may include neglecting the upkeep of the collateralized property, allowing junior liens to encumber the property, or insolvency. Although

these categories of carve-outs would qualify as “bad” acts, springing guaranties can also provide recourse to a lender upon the occurrence of an event that is not in the borrower’s control, such as the filing of an involuntary bankruptcy.

The extent of a nonrecourse debtor’s or guarantor’s liability upon a triggering event varies from loan to loan as well. Some carve-outs provide that a guarantor is liable for actual damages, while others provide that a lender is entitled to collect the entire accelerated loan balance from the guarantor upon a triggering event. Some carve-outs require the debtor and guarantor to waive an election of remedies defense.

Unlike the cases involving the waiver of bankruptcy rights, which would be argued as part of a motion to dismiss or a motion for stay relief in bankruptcy court, the “bankruptcy disincentive” cases are more likely to arise in state court or federal district court than in bankruptcy court.<sup>2</sup> A typical case is commenced with a Complaint filed by the Lender against one or more guarantors, for a deficiency after foreclosure, for breach of fiduciary duty, or for breach of guaranty. Fiduciary duty is based upon the guarantor / principal’s obligation to retain the sanctity of the single purpose entity.

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<sup>2</sup> A notable exception is *Bank of America, N.A. v. Lightstone Holdings (In re Extended Stay Inc.)*, 418 B.R. 49 (Bankr. S.D.N.Y. 2009). In that case, however, which was decided before *Stern v. Marshall*, 180 L.Ed.2d 475 (2011), came down, the bankruptcy court ruled that it did not have subject matter jurisdiction over the bank’s action to enforce non-recourse carve-out guaranty agreements made in connection with a mortgage loan secured by hotels owned by the Chapter 11 debtors. After *Stern v. Marshall*, it is even less likely that such a claim would be heard by a bankruptcy court.

Because both the triggering events and the extent of liability range so widely, decisions are fairly fact-based and the results vary. However, as a general proposition, most “bad boy” guaranties are enforced to some degree, notwithstanding some fairly persuasive public policy arguments against doing so. Even though the effect of bankruptcy disincentive provisions is to discourage a bankruptcy filing, state courts have almost uniformly held that “bad boy” guaranties that provide for springing recourse upon the filing of a voluntary petition are not contrary to public policy, since they do not prohibit a bankruptcy filing. Guarantor/principals are frequently found liable for filing a bankruptcy for a single-purpose entity borrower since the language of the loan documents did not bar access to the bankruptcy court; it merely specified the consequences for filing.

#### **Recent Case Law**

*GCCFC 2006-GG7 Westheimer Mall, LLC v Okun*, 2008 WL 3891257 (S.D.N.Y. Aug. 21, 2008) (“*Westheimer Mall*”) is fairly typical of the cases that have arisen recently. In *Westheimer Mall*, the lender made a non-recourse loan to the owners of a mall in Houston, Texas. One of the loan documents, the “Exceptions to Non-Recourse Guaranty” (the “Guaranty”) provided that the developer of the mall would personally guarantee payments on the loan in the event of a voluntary bankruptcy filing by any of the borrower entities, all of which he owned or controlled. The lender’s right under the documents to collect from the guarantor was wholly independent of any rights it held against the borrowers.

The lender was not required to file suit against the borrowers before pursuing the guarantor; nor was it required to exercise its rights in its collateral.

After the borrowers defaulted on the loan, the debt was accelerated and the lender noticed a foreclosure sale. Subsequently, the parties entered into a brief standstill agreement, pursuant to which the borrowers agreed to refrain from filing a bankruptcy petition. Notwithstanding these agreements, each of the borrower entities filed for bankruptcy protection before the foreclosure took place. Shortly thereafter, the assignee of the loan sued the guarantor for the accelerated amount due on the loan. The court granted summary judgment in favor of the lender, for the full amount due under the loan, including interest at the default rate, pursuant to the plain language of the Guaranty. The *Westheimer Mall* court did not address public policy concerns.

In *111 Debt Acquisition Holdings, LLC v. Six Ventures Ltd.*, 413 Fed. Appx. 824 (6<sup>th</sup> Cir. 2011) (unpubl.), guarantors appealed the district court's grant of partial summary judgment, awarding the lender the full amount of its deficiency after obtaining stay relief in the bankruptcy court and completing a foreclosure of the property. The lender's claim was based upon the occurrence of a "springing recourse event" ("SRE") under its loan documents – the filing of a bankruptcy case for the borrower by one of several guarantors. The non-filing guarantors argued, among other things, that the bankruptcy filing was unauthorized by holders of a majority of the interests in the debtor (indeed, the case was ultimately dismissed) and that an unauthorized bankruptcy filing cannot constitute an SRE.

Instead, they asserted, the filing should be treated as though it never occurred, and the guarantors should not be held liable. The district court held, and the Sixth Circuit Court of Appeals affirmed, that at least one of the guarantors failed to contest the bankruptcy filing and that, in accordance with the provisions of the loan agreement, guaranty liability was triggered.

Two cases decided by Michigan courts reached what may be the extreme in upholding springing guarantee liability. In *Wells Fargo Bank, NA v. Cherryland Mall L.P.*, 295 Mich. App. 99, 812 N.W.2d 799 (2011), the trustee of a REMIC trust foreclosed on an asset in an SPE and brought a deficiency action against the borrower and the guarantor under a springing guaranty. The loan documents provided that the loan obligation would become fully recourse as to the borrower and guarantor in the event that the borrower “fails to maintain its status as a single purpose entity as required by, and in accordance with the terms and provisions of the Mortgage.” In a separate section entitled “Single Purpose Entity / Separateness” the mortgage lists covenants for the borrower, including one that provides: “Mortgagor is and will remain solvent and Mortgagor will pay its debts . . . from its assets as the same shall become due.” Virtually identical requirements are set forth in the note. The trial court ruled that the borrower’s insolvency constituted a failure to maintain its SPE status and rendered the guarantor liable for the entire deficiency on the loan.

On appeal, the borrower and guarantor argued that the mortgage was extinguished upon its foreclosure and, therefore, the post-foreclosure deficiency

action, based upon the terms of the mortgage, was barred. The Court of Appeals ruled that the deficiency action was based upon the note, which was not extinguished by foreclosure, and that the note entitled the trustee to maintain its suit. The court then analyzed the language of the loan documents to determine whether the borrower's insolvency damaged triggered guaranty liability. After a thorough analysis, both of the contractual language and of the CMBS lending industry, the Michigan Court of Appeals concluded that the borrower and guarantor were liable under the loan documents.

The *Cherryland Mall* decision has been criticized by numerous commentators, and the court appeared to regret its decision. In addition to the provisions discussed above, the loan documents at issue also clearly provided that the loan became recourse upon the failure of the borrower to pay *any* debt when that debt became due. That provision rendered the stated non-recourse character of the debt a nullity, since it entitled the trust to pursue the borrower and the guarantor upon any default. As the Court stated, "We recognize that our interpretation seems incongruent with the perceived nature of a nonrecourse debt . . . . It is not the job of this Court to save litigants from their bad bargains or their failure to read and understand the terms of a contract."

Finally, the appellants raised public policy arguments in support of their position. The exact nature of these arguments was not clear from the Court of Appeals' decision; however, the Court ruled that policy considerations are not in

the purview of the legal system, but rather it is up to the legislature to make social policy.

A case with very similar facts, *51382 Gratiot Avenue Holdings, LLC v. Chesterfield Development Co.*, 835 F. Supp. 2d 384 (E.D. Mich. 2011), was decided by the Michigan District Court at about the same time as the *Cherryland Mall* case came down. The District Court in this case interpreted the lender's contract provisions to make the borrower and guarantor liable for the deficiency on the loan after foreclosure, based upon the insolvency of the SPE. The District Court also addressed in its opinion the defendants' contention that such an interpretation "does violence to the very nature of commercial mortgage-backed security loans, and the court's enforcement of those provisions as written will have disastrous consequences in the real estate market." Not surprisingly, the Court concluded that such dire predictions were irrelevant to the Court's duty to give effect to the loan documents.

There is a post-script to these cases, however. In March, 2012, the governor of Michigan signed into law a bill the "Nonrecourse Mortgage Loan Act", Senate Bill No. 992, which provides: "A post closing solvency covenant shall not be used, directly or indirectly, as a nonrecourse carve-out or as the basis for any claim or action against a borrower or any guarantor or other surety on a nonrecourse basis." The Michigan legislature went on to say: "The legislature recognizes that it is inherent in a nonrecourse loan that the lender takes the risk of a borrower's insolvency, inability to pay, or lack of adequate capital after the loan



is made and that the parties do not intend that the borrower is personally liable for payment of a nonrecourse loan if the borrower is insolvent, unable to pay, or lacks adequate capital after the loan is made.” The legislature expressly stated a post-closing solvency covenant used as a nonrecourse carve-out “is an unfair and deceptive business practice and against public policy; and should not be enforced.”

Public policy arguments were also unavailing in *UBS Commercial Mortgage Trust 2007-FL1 v. Garrison Special Opportunities Fund*, 33 Misc. 3d 1204, 938 N.Y.S. 230 (2011). In that case, the lender required a guaranty as part of a forbearance agreement after the borrowers defaulted. The guaranty became effective upon a bankruptcy filing by borrowers. The lender sued for payment on the guaranty after borrowers filed Chapter 11 petitions. The guarantor defended largely on public policy grounds – that the guaranty was an unenforceable penalty, since the potential liability was not quantified; it wrongly induced the guaranty to breach its fiduciary duties; and it impeded commercially desirable real estate finance restructuring. The court found that the guaranty was part of a legitimate financing arrangement and typical in the industry, and that the guarantor understood the risks if the borrowers filed bankruptcy. Thus, it was not an unenforceable penalty.

The guarantor further argued that guaranties that impose massive liability upon a guarantor for putting a borrower into bankruptcy could induce guarantors, in the exercise of their fiduciary duties as manager of the borrower, to refrain from filing a Chapter 11 petition to the detriment of the borrower’s creditors. The court

found that this situation was indistinguishable from a situation in which a parent guaranteed the debt of a subsidiary. “The legitimacy of such common arrangements is not subject to question under any theory of commercial law of which the court is aware.” The court disposed of the “clogging of the commercial arteries” argument as did the *Cherryland Mall* court, by ruling that any needed change was in the province of the legislature or executive branch.

One of the few cases denying guarantor liability had facts with potentially extremely harsh consequences. In *ING Real Estate Finance (USA) LLC v. Park Venue Hotel Acquisition LLC*, 907 N.Y.S.2d 437, 2010 WL 653972 (Feb. 24, 2010), the loan documents provided that the loan was non-recourse and that the lender could not seek a deficiency from the borrower or any other person. The guarantors of the loan signed a guaranty agreement, whereby they were obligated for certain amounts, depending on whether an event was a “Partial Recourse Event” or a “Full Recourse Event” as those terms are defined in the credit agreement between the parties.

The lender sued the guarantors for up to \$90 million for their failure to pay \$278,759.20 in real property taxes that were due two weeks earlier, since the taxes constituted an impermissible encumbrance on the property. The guarantors then promptly paid the taxes in full, removing the lien. As the New York Supreme Court framed the issue: “The question before the Court is whether, by the terms of the contract, the nineteen-day tardiness in paying less than \$300,000 in property taxes triggers a full recourse obligation by the Guarantors of up to \$90 million.”

There was some ambiguity in the loan documents as to whether the default constituted a Full Recourse Event for which there was no grace period, or a default for which the documents allowed a thirty-day cure period upon the filing of a lien. Because, under New York law, ambiguities in guaranty documents should be construed to the benefit of the guarantor, the court ruled that there was a 30-day grace period (and in any event, the taxes did not yet constitute a lien), the recourse provisions were not triggered, and the claims were dismissed.

At issue in *CSFB 2001-CP-4 Princeton Park Corporate Center, LLC v. SB Rental I, LLC*, 410 N.J. Super. 114 (2009), was a nonrecourse carve-out that rendered a debt fully recourse and a guaranty effective if, among other things, the borrower failed to obtain the lender's written consent before encumbering the lender's collateral with a subordinate lien. The lender sought a deficiency from the borrower and guarantor after a sheriff's sale of its collateral. The borrower had borrowed \$400,000 from another lender and given that lender a second mortgage, without obtaining consent from the senior lender. The debt was repaid, however, before the borrower defaulted on its obligations to the senior lender.

The defendants opposed the deficiency claim, arguing that the junior encumbrance did not result in any harm to the senior lender and that, therefore, a judgment in the amount of the deficiency would be more in the nature of an unenforceable penalty than damages. The court disagreed, finding that non-recourse carve-out provisions are not liquidated damages clauses because they do not assess likely damages. Instead, the carve-out provisions are designed to

discourage behavior that is deemed particularly risky, like creating junior encumbrances, by making guarantors and/or borrowers personally liable for the full amount owed to the lender. The court went on to say that the fact that the subordinate financing had been paid off well before the defendants defaulted on payment of the senior debt did not change the fact that the defendants breached their obligation to the lender, and had to suffer the consequences of their actions.

All is not lost for the guarantor of the obligation of a debtor that files a bankruptcy petition. Debtors have had some success in temporarily enjoining collection efforts against a guarantor who is instrumental to the implementation of a plan of reorganization. Under limited circumstances and for a limited time period, bankruptcy courts may uphold an injunction against enforcing a guaranty against a non-debtor guarantor.

The Ninth Circuit Court of Appeals should rule soon on whether a very limited injunction in a plan of reorganization is acceptable. In *In Re Linda Vista Cinemas, L.L.C.*, 442 Bankr. 724 (Bankr. D. Ariz. 2010), the bankruptcy court enjoined the lender from attempting to collect on payment guaranties pending plan confirmation. At the same time, the court required the debtor to move quickly to plan confirmation. The debtor then proposed a plan that would enjoin legal actions against the guarantors for the duration of the plan term, so long as plan payments were timely made pursuant to the plan. Even though the proposed plan was a full repayment plan, the court stated that it did not believe the lender would be harmed by the injunction, and the plan satisfied all of the other requirements for

confirmation, the court found that the proposed injunction violated 11 U.S.C. § 524(e) based on controlling Ninth Circuit law and denied confirmation. The debtor successfully certified its appeal of this issue directly to the Ninth Circuit, so the bankruptcy court's decision may not be the final word.

In *Meritage Homes of Nevada, Inc. v. JPMorgan Chase Bank, N.A. (In re South Edge LLC)*, 2012 WL 3262880 (D. Nev. Aug. 8, 2012), the appellant asserted that the bankruptcy court erred in approving certain exculpation and post-confirmation injunction provisions contained in the plan of reorganization. The injunction prohibited any causes of action against the liquidating debtor until all estate assets were administered. The exculpation provision stated that the debtor, estate representatives, consenting prepetition lenders, settling builders, and others would not be liable for any acts taken or omission in connection with the Chapter 11 case. The district court ruled that the injunctions did not act as a *de facto* discharge and were permissible. The court further found that the exculpation provision merely set a standard of care to be applied in the bankruptcy proceeding. Meritage also appealed provisions in the confirmation order stating that a repayment guaranty executed by Meritage was not satisfied or released through confirmation. In a curious decision, the court found that the bankruptcy court properly determined the impact of plan confirmation on Meritage's repayment guaranty *under bankruptcy law only*, and that "another forum" would have to resolve whether the plan affected the guaranty under applicable state law.

## Conclusion

If any consistent trends can be ascertained from the recent cases, they include the following. Bankruptcy courts will not enforce agreements not to file bankruptcy, and are highly skeptical of stipulations to waive any protections offered by the Bankruptcy Code. Springing or “bad boy” guaranties that discourage bankruptcy filing are almost universally accepted, even though their purpose is identical to the consensual waivers. After the United States Supreme Court’s decision in *Stern v. Marshall*, it is highly unlikely that any lawsuits between a lender and a guarantor will be decided in bankruptcy courts; thus, it is more likely than ever that “bad boy” guaranties discouraging bankruptcy filings will be enforced.

Courts will also usually uphold guaranties that spring into place upon the occurrence of other specific events, so long as the loan documents are clear and so long as the controlling state’s legislature has not enacted a law that prevents the court from enforcement. Accordingly, lawyers representing borrowers should scrutinize loan documents carefully and advise their clients of the risks that loans that are non-recourse in name will become fully recourse.



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