At one time in the not-too-distant past, “bad boy” guaranties provided additional protection to lenders in the event of serious malfeasance by borrowers or guarantors, such as fraud or misappropriation of funds. But with the explosive growth of non-recourse finance transactions in the past decade, particularly in the real estate area, lenders began to expand the scope of those guaranties to include as “bad acts,” among other actions, voluntary bankruptcy filings by borrowers. Once the economy soured, therefore, distressed borrowers and guarantors found themselves with a dilemma: forego using bankruptcy to effect an orderly restructuring or reorganization of borrower indebtedness or find yourself liable for hundreds of millions of dollars of formerly non-recourse debt. This sounds like a quandary that would make even a bad boy cry.

Not surprisingly, these previously non-contentious guaranties have emerged as a fertile source of conflict between lenders and borrowers and become the subject of several judicial challenges. Today we discuss two recent New York decisions: UBS Commercial Mortg. Trust 2007-FL1 v. Garrison Special Opportunities Fund L.P.,1 and Bank of Am. v. Lightstone Holdings, LLC,2 both of which enforce the “bad boy” guarantees at issue.

What Is a Bad Boy Guaranty?

A “bad boy” guaranty, also known as a “springing recourse” guaranty, is generally found in non-recourse financing transactions. These guaranties (and the related loan agreements with the borrowers) typically alter the liability of the borrower and guarantor under the financing transaction in two respects once triggered. First, the guaranty of the borrower’s obligations, usually given by an owner or principal of the borrower, will become operative (or “spring” into effect) upon the occurrence of one or more enumerated “bad acts.” Second, the non-recourse loan obligation of the borrower will convert into a recourse loan obligation, thereby making the borrower and the guarantor fully liable for all obligations relating to such transaction.

The “bad boy” guaranty serves an important purpose for a lender. By making full recourse liability the price to a borrower or guarantor of a “bad act,” it discourages such parties from taking steps that ostensibly may damage the lender’s collateral. Perhaps more importantly, such full recourse liability provides the lender with additional rights and remedial protection if such events nevertheless occur.

As noted above, these guaranties initially covered a narrow range of certain specified “bad boy” acts, such as fraud, waste, misappropriation and non-permitted transfers. That narrow range of acts has rendered these guaranties fairly non-controversial. Indeed, there have been very few legal challenges to the enforceability of bad boy guarantees until recently.

With the wave of financings over the prior decade, however, these guaranties often expanded beyond their list of enumerated “bad acts” to include bankruptcy filings (a development that paralleled the increased appearance of debtor non-petition covenants in loan documents). That broadened scope has not only given rise to litigation, it has raised the question as to whether the resulting constraint on voluntary bankruptcy filings is desirable for either lenders or debtors.

Improper Constraint?

While even borrowers and guarantors would concede that lenders ought to be able to protect themselves against truly “bad” acts, the legitimacy of the prevailing trend of “bad boy” recourse provisions to include a voluntary bankruptcy filing on their list of “bad acts” appears less certain.

With billions of dollars of loans coming due, borrowers and guarantors may have a legitimate business purpose—and, in some cases, a fiduciary duty—to seek bankruptcy protection. Bankruptcy courts have long been reluctant to enforce “non-petition” covenants of debtors (being agreements by debtors not to file a petition seeking bankruptcy relief). A provision that imposes recourse liability on a debtor for filing a bankruptcy petition could arguably be challenged as an unenforceable pre-petition waiver of the right to file bankruptcy, as well as a prohibited ipso facto clause.3

Given this judicial reluctance, it is not surprising that lenders would seek another approach to discourage bankruptcy filings by distressed debtors or at least to provide...
lenders with additional remedial protection. Lenders understandably often wish to navigate their borrowers away from chapter 11 filings, particularly given the protections they afford borrowers, the risks and uncertainty of the process for even fully secured lenders, and their potential for costly litigation.2 Moreover, bad boy clauses in guaranties should be better able to withstand judicial scrutiny, as non-bankrupt guarantors in general fall outside the protections of the Bankruptcy Code.

Reportedly, the existence of these guaranties has resulted in considerably fewer bankruptcy filings.3 While many lenders may instead be resorting to non-bankruptcy state law remedies, such as foreclosures, those processes can be, and often are, the subject of serious challenges by borrowers, guarantors and other secured lenders for reasons such as the failure to comply with statutory requirements, including commercial reasonableness. On the other hand, a sale conducted under §363 of the Bankruptcy Code (which would necessarily be a sale on terms approved by a bankruptcy court) can insulate a sale conducted by a debtor or bankruptcy trustee from challenge.4 While there are certainly circumstances in which out-of-court restructurings and reorganizations may be more effective for debtors, forcing debtors to follow such course may not always benefit either debtor or lender.

Lessons From Recent Cases

These competing commercial interests, when combined with the distress which engulfed the finance markets over the last few years, set the stage for renewed judicial consideration of once seldom-enforced “bad boy” guaranties. The resulting court cases have been fairly consistent. In general terms, lenders have argued for a strict adherence to the plain language of the “bad boy” guaranty, while borrowers and guarantors have opined the enforcement of “bad boy” guaranties on largely public policy and procedural grounds. And courts have sided with the lenders.

As noted above, two examples of these recent decisions are the Garrison and Lightstone cases, both of which were before Justice Melvin L. Schweitzer of the Commercial Division of New York State Supreme Court, New York County. In each case, despite numerous defenses raised by the guarantors, the court awarded the lenders summary judgment for the amount they sought to recover under the guaranty. Specifically, in enforcing the “bad boy” guaranty at issue, the decisions primarily held that “bad boy” guaranties (i) constitute “instruments for the payment of money only” sufficient to fall within the purview of New York CPLR 3213,2 (ii) are not unenforceable penalties and (iii) are not void as a matter of public policy.8

In Lightstone, the plaintiffs, Bank of America and other mezzanine lenders, financed the $8 billion acquisition of the Extended Stay Inc. (Extended Stay) hotel chain by real estate developer David Lichtenstein (Lichtenstein) and his company Lightstone Holdings, LLC (Lightstone) through a series of mezzanine loans totaling $1.9 billion. While the mezzanine loans were initially non-recourse, they became recourse under certain enumerated conditions, although the recourse liability of Lichtenstein and Lightstone as guarantors under the “bad boy” guaranties was capped at $100 million.

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On June 15, 2009, the Extended Stay borrowers filed voluntary petitions under the Bankruptcy Code. Pursuant to §9.4(b) of the mezzanine loan agreements, the bankruptcy filing caused the mezzanine loans to become fully recourse to the ESI Borrowers. On June 16, 2009, the plaintiffs notified Lichtenstein and Lightstone that they must pay $100 million as the primary obligors under the guaranties.

After Lichtenstein and Lightstone refused to pay any portion of the $100 million, Bank of America and the other mezzanine lenders moved in lieu of a complaint pursuant to CPLR 3213 for an order granting summary judgment with respect to the guaranty agreements in the amount of $100 million plus prejudgment interest.

The court ultimately rejected the defendants’ procedural and substantive arguments, and, in granting the motion, ruled that (i) the plaintiffs made a prima facie case for summary judgment under CPLR 3213 and (ii) the defendants failed to demonstrate that such summary judgment was inappropriate.9

While Lightstone captured headlines due to the high profile nature of the parties and the substantial size of the underlying mortgage loan, Garrison is notable for involving a “bad boy” guaranty given by a mezzanine lender who foreclosed on a guarantor’s equity interests in a borrower.

In that case, UBS Real Estate Securities Inc. (UBS) loaned $107 million to four limited liability companies for the purpose of acquiring certain office buildings in Reston, Virginia (the Properties). Facing a need for additional financing, the equity owner of the borrowers obtained a mezzanine loan in the amount of $31.5 million secured by a pledge of 100 percent of the membership interests in the borrowers. In December 2007, the secured mezzanine loan was assigned to Garrison Special Opportunities Fund LP (Garrison).

The borrowers failed to make payment to UBS on Aug. 9, 2009, the date the loan initially became payable in full. The borrowers then opted to exercise their right to extend the maturity date one year to Aug. 9, 2010. Once again, the borrowers did not make payment to UBS when the loan became due on the extended maturity date. After the borrowers again failed to pay the mortgage loan in full, Garrison, as the holder of the secured mezzanine debt, requested that UBS forbear from completing a foreclosure of the mortgage and divesting borrowers of title to the Properties.

As a condition to UBS’s agreement to forbear, on Sept. 28, 2010, Garrison executed a “bad boy” guaranty, pursuant to which Garrison unconditionally guaranteed to plaintiffs the payment and performance of the liabilities and obligations of the borrowers to the lender under the loan agreement to the extent such liabilities and obligations arose after Garrison’s acquisition of all or any part of the ownership interest in the borrowers. Among other things, like the facts in the Lightstone case, the Garrison financing provided that the amount of the loan would be fully recourse to the borrowers in the event the borrowers filed a voluntary petition under the Bankruptcy Code.

On Nov. 1, 2010, Garrison consummated a foreclosure sale on its collateral and acquired 100 percent of the ownership interests in the borrowers. On Dec. 15, 2010, each borrower filed a voluntary petition under the Bankruptcy Code in the U.S. Bankruptcy Court for the Southern District of New York. Five days later, UBS demanded payment from Garrison, the
mezzanine lender turned equity owner. When Garrison refused to pay, UBS promptly filed a motion for summary judgment in lieu of complaint (under CPLR 3213).

Justice Schweitzer rejected all of Garrison’s arguments, and held that Garrison, a sophisticated distressed investor, “was familiar with the Guaranty’s mechanics and purpose of the Guaranty” and “made a decision to take a calculated risk that it could arrange a refinancing of the Properties before being forced by an aggressive lender to initiate a bankruptcy proceeding to protect its economic interests.”

Unintended Consequences

While Garrison incurred personal liability as a result of its execution of a “bad boy” guaranty, the case raises interesting intercreditor questions about the potential for a mezzanine lender who has not signed a “bad boy” guaranty to trigger such guaranty. Once a mezzanine lender forecloses on and acquires the guarantor’s equity interests in the borrower, it effectively takes control of the borrower. After foreclosure, the mezzanine lender turned equity owner can then unilaterally place the borrower and/or guarantor into bankruptcy. A mezzanine foreclosure.

If the mezzanine lender commits any acts that trigger the “bad boy” guaranty. Finally, debtors with the leverage to negotiate such limitations may insist that such guaranties expire if those parties are no longer in control due to a mezzanine foreclosure.

Conclusion

When read together, the Lightstone and Garrison decisions impart a meaningful warning to lenders and debtors alike. Even in the face of numerous procedural and substantive arguments, “bad boy” guaranties appear to withstand scrutiny.

However, lenders may find that these guaranties are not helpful in all instances and, in certain situations, may even prove detrimental to their interests. While the “bad boy” guaranty has the practical effect of reducing the number of bankruptcy filings, this inability to file troubled companies for bankruptcy may prevent the efficient restructuring of distressed debt. Whether this is a positive development for either lenders or debtors remains to be seen.

3. See §365(e)(1) of the Bankruptcy Code, which provides as follows:
   Notwithstanding a provision in an executory contract or unexpired lease, or in applicable law, an executory contract or unexpired lease of the debtor may not be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on—
   (A) the insolvency or financial condition of the debtor at any time before the closing of the case; or
   (B) the commencement of a case under this title; or
   (C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.
5. Id.
6. Note that while the terms of sales in bankruptcy may be the result of negotiations with creditors, the bankruptcy court protection will extend only to sales by debtors in bankruptcy or bankruptcy trustees; lender-conducted sales would be conducted under state law after relief from the automatic stay.
7. An action permitted under CPLR 3213 is very advantageous for a lender in that it allows for an expedited proceeding. CPLR 3213 provides: “When an action is based upon an instrument for the payment of money only or upon any judgment, the plaintiff may serve with the summons a notice of motion for summary judgment and the supporting papers in lieu of a complaint.”