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Non-Recourse Loans & Bad Boy Guaranties

If you have financed commercial real estate in the past 10 years, chances are that you have considered obtaining a non-recourse loan. Non-recourse loans are popular with commercial real estate owners because owners believe it allows them to shield their personal assets from liability by limiting their liability for the loan to the owner's interest in the real property securing the loan. Unfortunately, that is not always the case.

For almost all non-recourse loans, borrowers and individual key principals are required to sign non-recourse carve-out guaranties, commonly known as "bad boy guaranties." By signing a "bad boy guaranty" individual key principals can be held personally liable for the full amount of the loan and for losses suffered by the lender, with the reach of such liability extending to the personal assets of the borrower and its key principals. "Bad boy guaranties" were intended to make borrowers and individual key principals personally responsible for true "bad boy" actions like fraud, misrepresentations, and misappropriation of rents and insurance proceeds and certain other actions within their control. However, the scope of personal liability under "bad boy guaranties" has been expanded significantly over the last several years so that owners are personally liable for a number of other actions like failing to maintain insurance, failing to deliver financial reports, bankruptcy by the borrower or key principals, transfers of the property or interest in borrower entities, failure to comply with "single purpose entity" requirements, etc. Many times these types of guaranties impose personal liability for actions routinely taken by borrowers without obtaining lender consent like changing bank accounts or replacing the property manager. After the "great real estate recession" some courts have started to strictly enforce the terms of "bad boy guaranties" against owners. Owners who are not aware of potential personal liability under a "bad boy guaranty" risk the catastrophic result of inadvertently becoming personally liable for repayment of the entire amount of the loan because of a technical violation of the terms of the guaranty.

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Considering the expanding scope of personal liability under "bad boy guaranties" and courts strict enforcement of such liability, commercial real estate owners who are thinking about signing up for a non-recourse loan should take great care to review the loan documents to understand exactly what is their personal liability under the "bad boy guaranty" and then limit that liability.

Vijay Pai is a real estate and finance partner at Rutan & Tucker, LLP with substantial experience representing lenders, developers and landlords in the structuring, negotiation and documentation of real estate and finance transactions. Vijay Pai has represented institutional lenders, second lien lenders and borrowers in a broad range of finance transactions including real estate secured loans (construction, permanent, mezzanine and affordable housing loans) and non-real estate secured asset-based and second lien financing transactions. His practice also includes representing buyers and sellers in connection with the acquisition and sale of real property with a special emphasis on multi-family housing properties. Vijay can be reached at vpai@rutan.com or 714.662.4620.