

Negotiating Commercial Loan Guaranties

Non-Recourse Terms and Conditions, Net Worth and Liquidity Covenants,
Guaranties of Interest Rate Swap Obligations and More

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OVERVIEW OF RECOURSE CARVEOUTS IN NON-RECOURSE MORTGAGE LOANS

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What is a “non-recourse loan”?

A non-recourse loan is a loan where the applicable lender agrees that its enforcement remedies are limited to the Property (including the real property, fixtures and personal property) and the applicable borrower is not personally liable for the debt.

Typically, there are exceptions or “carveouts” to this agreement by Lender. These are referred to as “recourse carevouts”.

Why are recourse carveouts required?

Lenders often require carveouts:

- (1) To mitigate “moral hazard” or “bad boy” acts.
- (2) As credit support.
- (3) To address Property level / collateral level issues.

What are typical recourse carveouts?

Recourse carveouts typically fall into two categories – those “Losses” and “Full Recourse”.

“Loss” carveouts are limited to losses incurred by the lender due to the applicable carveout. They are typically referred to as “above the line” carveouts due to where they appear in the typical loan document recourse provision.

What are typical recourse carveouts – *continued*

These typically include:

1. Fraud or intentional misrepresentation.
2. Gross negligence/willful misconduct.
3. Breach of environmental representation, covenant, or indemnity.
4. Litigation delaying, contesting or impeding lender's remedies
5. Waste.
6. Misapplication, misappropriation or conversion by Borrower of (a) insurance proceeds, (b) condemnation awards, (c) security deposits and (c) rents after Event of Default.
7. Failure to pay taxes or other charges that can create liens on the Property.
8. Failure to pay recording and transfer taxes

“Full Recourse” carevouts make the debt fully recourse upon the occurrence of the applicable carveout. They are typically referred to as “below the line” carveouts due to where they appear in the typical loan document recourse provision.

These typically include:

1. Breach of cash management provisions
2. Breach of transfer / due on sale provision
3. Breach of SPE provisions
4. Bankruptcy involving Borrower or the Property
5. Securitization cooperation provisions

Who is liable under the recourse carveouts?

These carveouts extend to Borrower and, frequently, to another natural person or entity. Those persons are commonly referred to as “Recourse Guarantors”.

Recourse Guarantors execute a guaranty of the recourse carveouts in connection with the closing of the loan.

Both tests exclude any interest in the Property.

Who is liable under the recourse carveouts – *continued*

Lenders typically require Recourse Guarantors to be:

1. An affiliate of Borrower (such that the “behavioral” aspects of the recourse carveouts have some impact).
2. A natural person or entity with assets other than the Property.

Lenders often ask for financial reporting and net worth and liquidity covenants from Recourse Guarantors.

Breach of these covenants creates an event of default under the loan.

Net worth is typically 100% of the loan amount. Liquidity is typically 25% of the loan amount.

Both tests exclude any interest in the Property.

What are typical points of negotiation for recourse carevouts?

1. What persons / entities are going to serve as recourse guarantors
2. Cash flow qualifiers
3. Above the line / below the line / bifurcated
4. Caps on liability
5. Items driven by non-con opinions
6. Nw / liquidity covenants, levels and tests
7. Availability of reserves

Negotiating Commercial Loan
Guarantees:
Interest Rate Swaps

Bill Holland

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Overview of “Eligible Contract Participant” Requirements

- Under the Commodity Exchange Act, only Eligible Contract Participants may enter into “over-the-counter” swaps
 - Alternative to over-the-counter is to enter into swaps on, or subject to rules of, a board of trade designated by the Commodity and Futures Trading Commission
- Commodity Exchange Act Section 2(e).

Definition of Eligible Contract Participant

- The term “eligible contract participant” means ... a corporation, partnership, proprietorship, organization, trust, or other entity:
 - (I) that has total assets exceeding \$10,000,000;
 - (II) the obligations of which under an agreement, contract, or transaction are guaranteed or otherwise supported by a letter of credit or keepwell, support, or other agreement by an entity described in subclause (I) ... ; or
 - (III) that—
 - (aa) has a net worth exceeding \$1,000,000; and
 - (bb) enters into an agreement, contract, or transaction in connection with the conduct of the entity’s business or to manage the risk associated with an asset or liability owned or incurred or reasonably likely to be owned or incurred by the entity in the conduct of the entity’s business;
- CEA Section 1(a)(18)(A)(v).

Definition of Eligible Contract Participant, Cont.

- An ECP can also be an individual who has amounts invested on a discretionary basis, the aggregate of which is in excess of
 - (I)\$10,000,000; or
 - (II)\$5,000,000 and who enters into the agreement, contract, or transaction in order to manage the risk associated with an asset owned or liability incurred, or reasonably likely to be owned or incurred, by the individual;
- CEA Section 1(a)(18)(A)(xi).
- Note 2012 changes replace “total assets” test with “amounts invested” test

Definition of ECP: CFR Clarifications

- For purposes of determining whether an entity has a \$1MM net worth for purposes of clause (III) above, the net worth of all direct owners (not including shell companies) of an entity can be taken into account, along with the entity, so long as each such owner is an ECP and the swap is used to “hedge or mitigate commercial risk”
- CFR Section 1.3(m)(7).

Dodd Frank Rules Relating to Swap Guaranties

- Effective March 31, 2013, CFTC rules expanded the definition of “swap” to include any guaranty of any swap
- Thus, each guarantor of a swap (in addition to the swap counterparty itself) must also qualify as an ECP or the guaranty may be illegal and/or invalid

Loan Agreement Guaranties: The Problem

- Most commercial loan agreements (and almost every syndicated commercial loan agreement) define “Obligations,” “Secured Obligations” and/or “Guaranteed Obligations” to include all swap agreements with the lender (or any bank member of the lending syndicate)
- In addition, most commercial loan agreements require all (or substantially all) of the borrower’s subsidiaries to guaranty the “Obligations,” “Secured Obligations” and/or “Guaranteed Obligations” regardless of the credit quality of any such subsidiary

Loan Agreement Guaranties: The Solution

- Since many subsidiary guarantors may not be ECP's (now or in the future), lenders are now taking the approach of excluding any non-ECP guarantor from the swap guaranty
 - Still on the hook for the loan guaranty and any other non-swap obligations

Loan Agreement Guaranties: The LSTA Approach

- “Excluded Swap Obligation” means, with respect to any Guarantor, any Swap Obligation if, and to the extent that, all or a portion of the Guarantee of such Guarantor of, or the grant by such Guarantor of a security interest to secure, such Swap Obligation (or any Guarantee thereof) is or becomes illegal under the Commodity Exchange Act or any rule, regulation or order of the Commodity Futures Trading Commission (or the application or official interpretation of any thereof) by virtue of such Guarantor’s failure for any reason to constitute an “eligible contract participant” as defined in the Commodity Exchange Act and the regulations thereunder at the time the Guarantee of such Guarantor or the grant of such security interest becomes effective with respect to such Swap Obligation. If a Swap Obligation arises under a master agreement governing more than one swap, such exclusion shall apply only to the portion of such Swap Obligation that is attributable to swaps for which such Guarantee or security interest is or becomes illegal.
- LSTA Market Advisory February 15, 2013 Swap Regulations’ Implications for Loan Documentation

Loan Agreement Guaranties: The LSTA Approach, Cont.

- Keepwell. Each Qualified ECP Guarantor hereby jointly and severally absolutely, unconditionally and irrevocably undertakes to provide such funds or other support as may be needed from time to time by each other [Loan Party] to honor all of its obligations under this Guaranty in respect of Swap Obligations (provided, however, that each Qualified ECP Guarantor shall only be liable under this Section ___ for the maximum amount of such liability that can be hereby incurred without rendering its obligations under this Section ___, or otherwise under this Guaranty, voidable under applicable law relating to fraudulent conveyance or fraudulent transfer, and not for any greater amount). The obligations of each Qualified ECP Guarantor under this Section shall remain in full force and effect until a [Discharge of Guaranteed Obligations]. Each Qualified ECP Guarantor intends that this Section ___ constitute, and this Section ___ shall be deemed to constitute, a “keepwell, support, or other agreement” for the benefit of each other Loan Party for all purposes of Section 1a(18)(A)(v)(II) of the Commodity Exchange Act.
- “Qualified ECP Guarantor” means, in respect of any Swap Obligation, each [Loan Party] ***that has total assets exceeding \$10,000,000*** at the time the relevant Guarantee or grant of the relevant security interest becomes effective with respect to such Swap Obligation or such other person as constitutes an “eligible contract participant” under the Commodity Exchange Act or any regulations promulgated thereunder and can cause another person to qualify as an “eligible contract participant” at such time by entering into a keepwell under Section 1a(18)(A)(v)(II) of the Commodity Exchange Act.
- Id.

Loan Agreement Guaranties: Alternative Approaches

- Separate loan guaranties from swap guaranties (more common in real estate financings)
- Draft loan agreement so that borrower's "Obligations" include all obligations of the subs (which includes all obligations of the borrower) so that keepwell automatically applies
- Rely on CFR 1.3(m) clarification so long as borrower/owner has a \$1MM net worth
- Do separate analysis of each subsidiary guarantor at the time any swap is entered into (which is the only time the ECP rules apply)

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Guaranty

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Guaranty Structuring Errors

- *The overlooked guarantor.*
 - Corporate.
 - Personal / trusts
- *Confusing co-borrower and guarantor status.*
- *Failing to secure the guaranty*
- *Regulation B*

Guaranty Structuring Errors (cont.)

- *Ignoring fraudulent transfer risks.*
 - Limiting the guaranty
 - Dealing with “equivalent value”
- *Ignoring letter of credit alternative*

Guaranty Documentation Errors

- *Failure to include requisite waivers.*
- *Failure to include covenants in the guaranty.*
- *Improperly limiting the guaranty.*
- *Overlooking value of notarization.*

Guaranty Enforcement Pitfalls

- *Inadvertently limiting recourse against the guarantor.*
- *Not considering whether the guarantor's consent should be obtained.*



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