BE CAREFUL WHAT YOU PROMISE:
A CRITICAL, CROSS-BORDER DISCUSSION OF
GUARANTIES, INDEMNITIES AND “BAD BOY” CARVE-OUTS

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Don’t be a “Bad Boy” - Non-Recourse Carve Out Guaranties and Indemnities Revisited
A Soup to Nuts Basics of Bad Boy Guaranties for the Commercial Dirt Lawyer

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I. Introductory Question: Who is liable?

a. Similar Inquiries for Borrower, Indemnitor and Guarantor
   i. Individual(s)
      • If an individual, do they own the collateral?
      • Counsel your lender clients: if a high wealth individual is your obligor, most likely is using trusts – will want obligations to attach to borrower’s/guarantor’s and trust’s assets
      • Do they have capacity (and authority when applicable) to enter into loan?
      • If married, whose assets are considered in credit decision?
      • Spouse issues:
         o Is collateral a marital asset?
         o Are marital assets included in credit decision?
         o Will spouse consent to co-liability?
         o If no, will spouse agree borrower’s individual assets and either all or borrower’s interest in marital assets subject to liability?
         o Also, if no will spouse confirm financial statements not include spouse’s assets, and that any assets subsequently transferred from borrower or marital property to spouse are subject to liability
         o Also consider if a spouse’s credit is required or necessary to bind her/his part of the marital assets, or if the signature is being required in violation of the federal Equal Credit Opportunity Act (aka “Reg B” or “ECOA”) (see 15 USC §1691, also 12 CFR Parts 202.1 et. seq., 1002.1 et. seq.) ECOA has been held to apply in guaranties. See RL BB Acquisition LLC v. Bridgemill Commons Dev. Group, LLC, 754 F.3d 380 (6th Cir. 2014); see, also, Hawkins v Community Bank of Raymore, 577 U.S.___ U.S. S. Ct. Case #14-520 (case #14-520, slip opinion dated 3/22/16) and its underlying 8th Circuit decision under Case No. 13-3065 decided 8/5/14.
      • Dead Guarantors:
         o Will want to check state law to file claims
         o Lender might initiate action to require estate set aside funds to satisfy contingent obligation
         o Replacement guarantor – Lender’s deadline will be before time limit for asserting claim against estate
ii. Entities

1. Basics Applicable to Most Entities
   A. Check entity documents for authority and limitations
      • Likely need resolutions or entity action
      • Both to approve loan and designate signatories
      • Opinion letter from counsel for borrower, indemnitor, guarantor
   B. Do they need to be registered to do business in state?
   C. Are they in good standing?

2. Special Issues for Partnerships
   • If a GP or LP, then general partners should have same liability as the borrower entity, consider impact of obtaining a guaranty from a general partner
   • For dirt loan, guaranty may be “sham” and unenforceable attempt to circumvent anti-deficiency limitation after certain foreclosure
   • Guaranty might also be viewed as limiting general partner’s otherwise unlimited liability

3. Special Issues for Trusts
   • For authority may have statutory trustee’s certificate – recite that lender can rely on certificate for authority
   • Certain states require notice to beneficiaries for major transactions – if so, include recital in the trustee’s certificate
   • Consider type of trust, ability to reach trust assets and limitations for trust transferring assets

b. Additional Considerations
   i. Whose assets included in credit decisions
   ii. Authority and ability to reach assets
   iii. Limitation on transfer of assets, minimum tangible net worth requirements?
   iv. Financial reporting to check on assets?
   v. Individuals may want ability to make gifts
   vi. Entities transfer assets, make distributions, conduct business in ordinary course

c. Multiple Obligors
   i. Joint Liability: Each is 100% liable for the guaranteed obligation – performance by one obligor discharges [may discharge] other guarantors
   ii. Joint & Several Liability: each guarantor 100% liable for obligations, but text used to give obligor who satisfies claim the ability to recover contributions from other obligors
   iii. Several Liability: proportionate share: liability is allocated up front among obligors on a percentage basis
      • Each obligor only liable for specific portion of obligations
      • Consider how proportions are determined (e.g. ownership in borrower)
Drafting tip: Consider also whether the proportionate share applies to the bad-boy/carve-out guaranties

Iv. Accommodation Maker? Watch for a co-signor who is a disguised guarantor/surety – i.e. not getting a benefit for giving the instrument. See, generally, UCC 3-419.

II. Indemnity vs. Guaranty
a. Basic Overview Question: What is a Guaranty?
   - A guaranty is the promise to the lender to answer for the debt or other obligation of another.
   - In many jurisdictions, guaranties are divided into two categories – a guaranty of payment and a guaranty of collection.
     - A guaranty of collection is an absolute and unconditional promise to pay the debt upon default or maturity if not paid by the principal obligor (the borrower), conditioned upon the lender exhausting remedies set forth in the guaranty, such as proceeding against the borrower.
     - A guaranty of payment is a promise to answer for the debt of the borrower without resort by the lender to any other party including the borrower.
   - Both guaranties of payment and guaranties of collection require a three party transaction (the borrower, lender and third party guarantor), as the obligation of the guarantor is separate and distinct from that of the borrower. Guaranties of payment are much more common than guaranties of collection as they are far more favorable for the lender.
   - More general background see Restatement (Third) of Suretyship & Guaranty (1996)

b. Basic Overview Question: What is an Indemnity?
   - An indemnity is a promise made by the indemnitor to reimburse another party, the indemnitee, should a stated liability arise.
   - Unlike a guaranty, an indemnity is a two party transaction and the indemnitor is directly liable for a breach of the indemnity, as opposed to a guarantor who is secondarily liable for the debt of the borrower.

c. Remember your basic elements for enforceability:
   - Authority
   - Acceptance/Assent (usually waived in document: “Guarantor hereby waives notice of acceptance of this Guaranty...”)
   - Consideration (recite the consideration; watch for past consideration; consider promissory estoppel as possible defense to defective consideration)
   - Writing (check state law for statute of frauds requirements)

III. Recourse vs. Non-Recourse Liability – General Background
a. General rule: silence = full recourse liability (but still need to determine if guaranty of payment or guaranty of collection)
b. c.f. UCC 9-607: collection and enforcement generally include right to seek payment; UCC 3-415(b) an endorsement must state “without recourse” or otherwise disclaim liability of endorser).

Side note: there are tax implications on recourse vs. non-recourse debt that rea not included in this paper. See, e.g. IRC 752; Blake D. Rubin, Andrea Macintosh Whiteway, John Finkelstein, Recourse or Nonrecourse: Treatment of Liabilities in a Complex World, ALI-ABA Course of Study, 2011: Creative Tax Planning for Real Estate Transactions.

b. Full Recourse Preferred by Lenders
   i. Lender can reach all borrower’s, indemnitor’s or guarantor’s assets, not merely collateral pledged to secure obligation
   ii. Usually seen with construction loans, but for permanent loans non-recourse or limited recourse loans prevalent (see discussion on carve-out liability below).
   iii. Some recourse limitations from state anti-deficiency statutes
       • If lender forecloses on collateral, may be limited from pursuing other assets
       • Usually applies for non-judicial foreclosures (so lender may elect a judicial foreclosure or sue on the note, in order to recover more than collateral)
       • Some states, commercial loans will permit deficiency recovery against guarantor or indemnitor after a non-judicial foreclosure; provided certain procedures, notices and deadlines satisfied

c. Non-Recourse Liability Preferred by Borrower, Indemnitor and Guarantor
   i. Limits lender’s recovery after loan default to collateral – used by borrower when it owns more than pledged collateral (in other words is not a Single Asset Entity or Single Purpose Entity – aka “SPE”)
   ii. Usually exceptions: environmental indemnities, bad boy guaranties (see below), other indemnities

d. Carve-Out and Springing Liability – Bad Boy Guaranties – General Description
   • Lenders identify defaults that pose special risks and carve them out of the general non-recourse provisions. Some carve-outs are limited to the damage a lender or the collateral might incur due to an event or omission, others trigger full recourse liability.
   • Carve-outs provide for protection that lenders require, personal liability, to insurance the incentive to repay the loan and maintain the viability of the collateral. Heller Financial, Inc., v Lee, 2002 WL 1888591, (N.D. Ill. 8/16/2002)(citing Portia Owen Morrison and Mark A. Senn, Carving up the ‘Carve-Outs’ in Nonrecourse Loans, 9-June Prob. & Prop. 8 (1995).

IV. General Guaranty Law – Suretyship; Waivers

a. Guaranty vs. Surety?
   • Some states no distinction, such as California. See Engelman v Bookasta, 264 Cal. App.2d 915 (1968).
• Other states make a distinction in terms of their relationship with a principal, with differences in notice requirements, with others requiring use of specific terms and others looking at substance.

• For an exhaustive discussion of Guarantors and Sureties, see Penelope L. Christophorou, Neil B. Cohen, Patrick A. Guida, Brian D. Hulsle, Commercial Lending Today: Sureties and Guarantors (ALI CLE May 2016)

b. General Rules:
   i. Guarantor is a “favorite of the law”
   ii. Assume guaranties will be strictly construed in favor of guarantor
   iii. In addition to suretyship defenses, consider if defenses available to borrower that could also be raised by guarantor
   iv. Suretyship defenses are designed to protect the guarantor from changes to the underlying obligation, such as modification of the debt, impairment of recourse or the lender’s failure of presentment, demand or protest to Borrower. States vary on whether a suretyship defense relieves a surety entirely or only to the extent the change harmed the guarantor.
   v. Some guaranty/suretyship defenses are waivable at time guaranty granted, but others cannot be waived at time of guaranty (again, state specific, please check current state statutes and case law). The waivers are intended to establish the guaranty as a stand-alone enforceable contract, regardless of changed circumstances concerning the original borrower or obligation.
   vi. Waivers.

   • For standard suretyship waivers, see Appendix 1 for examples (but remember state law specific).

   vii. Why some defenses not waivable up front:
      • Could be statutory or public policy limitation (e.g. may not waive anti-deficiency defenses, redemption rights)
      • Under UCC9 a waiver of commercial reasonableness in disposition of collateral is not enforceable.
      • Some waivers not effective because the guarantor’s right to asset a defense has not matured until after a default, accordingly in a post-default agreement lender might require waiver of these defaults “in consideration” for lender agreed to defer prosecuting claim or restructuring debt
      • A guarantor cannot waive its own ultra vires defense
      • Some states (e.g. California) have statutory requirements for valid waivers
      • Sample cases on enforceability of waivers:  
        • Engelman v Bookasta, 264 Cal. App.2d 915 (1968): enforcing numerous waivers, frequently used by creditors to enforce a guaranty without first exhausting collateral securing a loan.
        • California Bank & Trust v Delponti, 181 Cap. Rptr. 3d 216 (2014): a waiver of all defenses “except as prohibited by law” is not enforceable to waive the defense of lender’s misconduct (this
might be considered a public policy exception as well, prohibiting the lender from capitalizing on its own misconduct).

V. General Full Recourse Guaranty
   a. A recourse guaranty allows a lender to attach not only the collateral, but also to seek judgment against the guarantor’s personal assets. Black’s Law Dictionary 98th ed. 2004

VI. Carve Out aka Bad Boy Guaranties: Partial Recovery (loss or damages)
   a. How documented
      i. Usually one document with a partial and full recourse sections, plus representations, warranties, waivers of suretyship and other defenses (e.g. statute of limitations, jury trial, etc. – watch state law limitations on waivers, and state specific statutory waiver text)
      ii. Occasionally two documents: if so, consider whether the partial recovery (damages) is better as an indemnity vs a guaranty?
   b. General idea: Lender can recover from the Guarantor the amount of Guarantor’s loss or damage incurred arising from certain events, actions or omissions
   c. Usual Carve Outs:
      • Fraud or intentional misrepresentations
        o Could be by borrower or guarantor
        o May be limited to matters concerning the property, leases, making and delivery of loan documents or any other materials or information provided by or for borrower or guarantor in connection with loan
        o Some lenders designate fraud as springing full recourse trigger
      • Environmental: breaches of representations, warranties, covenants
      • Removal or disposition of collateral (sometimes limited to after a default)
      • Misapplication of security deposits, tenant tax and insurance escrows, insurance proceeds, condemnation proceeds
        o Lender will include failure to turn over security deposits and tenant escrows if there is a foreclosure
        o Loan documents may allow application of insurance or condemnation proceeds to restore improvements – guarantor should confirm text in guaranty permits such actions as well as rights granted under state law – see, for example, Schoolcraft v. Ross, 81 Cal App 3d 75 (1978) and California Code of Civil Procedure Section 1265.225.
      • Income from property not applied to pay loan (or otherwise as required under loan documents)
        o Guarantor should try to limit to only income received during a loan default or for capital improvements to the collateral.
        o Lender will include as part of this carve-out or separately, any judgments, termination payments, settlements with tenants
      • Judgments, settlements, payments, including in connection with litigation, relating to defects in improvements located on the property, not applied as required under loan documents
        o Guarantor should negotiate for ability to limit liability if funds were not applied to restore the improvements or paid to lender
• Failure to maintain collateral
  o May be expanded: failure to manage, operate and maintain property in a commercially reasonable manner for similar property types in same geographic area
• Damage to value of collateral due to waste
  o Guarantor may try and limit to intentionally or grossly negligent waste committed or permitted by guarantor or borrower (lender will add or their Affiliates)
  o Consider defining waste, lender should include any material abuse or destructive use (whether by action or inaction)
• Removal of personal property or fixtures and not replaced as required under loan documents
  o Lender should include its cost to replace such personal property or fixtures
• Failure to timely insure collateral as required under loan documents
  o Lender may expand to include penalties, late charges and interest
  o Lender may expand to include cost of restoring any casualty not covered by insurance, including deductibles
  o Some lenders move this to springing full recourse – beware
• Failure to pay property taxes and other assessments
  o Include penalties, interests, late charges, losses relating to sale or forfeiture of property due to failure to pay taxes
  o Some lenders move this to springing full recourse - beware
• Failure to pay for labor or materials
  o Guarantor try and limit to those that create liens or judgments that are not timely removed pursuant to borrower’s rights under loan documents
• Failure to perform landlord obligations under leases
  o Lender should specifically include recovery of funds expended by lender to fulfill such obligations (but take care in drafting so recovery not limited to only funds expended, and not drafted to require lender to act)
• Acts of terrorism (this is usually added if terrorism insurance (or “no exclusions for acts of terrorism”) is not an insurance requirement under loan documents)
• Breaches of easements or Permitted Exceptions (this should be customized by lender to specific property)

d. Special Circumstances
• Damages arising from SPE violations (see Full Recourse as well)
  o Borrower failing to be an SPE at loan closing and at all time during term of loan
  o Filing by anyone of a motion for substantive consolidation or joint administration citing Borrower’s failure to remain an SPE
  o Lender should clarify the damages/loss liability under this section is in addition to any Springing Full Recourse Guaranty liability for SPE violations
• Also used as a catch-all when unusual circumstances for collateral
  o Certain environmental clean-up or history
Concerns with specific leases or tenants
Specific covenants in loan documents (e.g. use of union labor or compliance with prevailing wage)

e. Less Frequent Provisions

- Intentional breach of applicable laws
- OFAC, USA Freedom Act or Money Laundering Violations
  - Lender may try for Springing Full Recourse. Particularly if fraud

VII. Bad Boy Guarantees – Springing Full Recourse

a. General idea: Guarantor becomes liable for the entire loan upon occurrence of certain events, actions or omissions

b. Usual Carve Outs

i. Unpermitted Transfers of Collateral or Interest in Borrower
   - Usual violation is any voluntary transfer of interest in property or borrower, unless lender permits
   - Check loan documents - they usually allow certain transfers without triggering defaults – guarantor should require text confirm that only transfers that trigger loan defaults trigger the springing full recourse under the guaranty
   - Transfers often specifically negotiated in loan documents:
     - transfers by operation of law,
     - transfers for estate planning (but lender may require transferee to assume liability – at least to extent of transfer)
     - transfers to related entities (if they assume liability)
     - unrelated transfers that lender approves
   - Other unpermitted transfer could be junior liens or pledges of ownership interest in borrower (or further upstream) aka “mezzanine loans”
   - Some cases, failure to clear liens (but guarantor should argue involuntary liens and statutory liens are not “voluntary” and liability should be limited to damage/loss to lender – best to have it listed in partial bad boys for clarity).

See Heller Financial Inc. v. Lee, 2002 WL 1888591, (N.D. Ill. 8/16/2002), see also, JLM Financial Investments 4 v. Aktipis, 2013 WL 2434607 (N.D. Ill. 6/3/2013)(lender’s attempt to claim full recourse carve-out liability denied where mechanics lien was not a voluntary lien or transfer); CP III Rincon Towers v Cohen, 13 F. Supp. 3d 307 (S.D.N.Y. 2014)(referencing bankruptcy law to distinguish between voluntary and involuntary liens to prevent full recourse carve-out; refusing to find full recourse liability even where mechanics lien was not a voluntary lien or transfer); but see 8375 Honeytree Boulevard Holdings, LLC v. Starman, 2012 WL 683379 (E.D. Mich. 3/2/2012) (mechanics liens found an impermissible transfer, one of the grounds for finding full recourse liability triggered).

- Forfeitures as unpermitted transfer
forfeiture because of conduct or purported conduct of criminal activity by borrower, guarantor, principal (consider how this applies to the current mess with cannabis laws)

ii. Fraud
   • Guarantor may try to move this up to partial recourse damages/loss liability (see above)

iii. Insolvency Events: Receivership, Bankruptcy or Equivalent
   • Appointment of receiver (for borrower, any guarantor, over the collateral)
   • General assignment for benefit of creditors
   • Bankruptcy filing where borrower or any guarantor is debtor
     o Lender should expand to include “a petition in bankruptcy or insolvency, or a petition or answer seeking any reorganization, arrangement, composition, readjustment, liquidation, dissolution or similar relief under the bankruptcy code, other insolvency laws, or any other applicable federal, state or other entity’s statute or law”
   o Borrower and guarantor should try for distinction for involuntary filings
     o Full recourse if complicit (which could be described to include soliciting petitioning creditors to file a bankruptcy petition)
     o Lender may also require full recourse for involuntary if debtor does not get case promptly dismissed (60-90 days)

   • Cases enforcing full recourse liability:
     o 111 Debt Acquisition Holdings, LLC v. Six Ventures Ltd, 413 Fed. Appx. 824 (6th Cir. 2011) Not For Publication (even a bankruptcy petition filed without proper corporate authority, and even where guarantor objected to bankruptcy filing, full recourse guaranty liability triggered).
     o 8375 Honeytree Boulevard Holdings, LLC v. Starman, 2012 WL 683379 (E.D. Mich. 3/2/2012) (full recourse liability triggered: mechanic’s liens were impermissible transfers, and unauthorized bankruptcy filing).

iv. SPE Violations
   • Usual text is “any violation of Borrower’s single purpose entity (SPE) covenants in the loan documents and such breach results in substantive consolidation [or joint administration] of borrower with any affiliate, in a bankruptcy, receivership, insolvency or similar proceeding.”

c. Borrower and guarantor should take care to review SPE covenants to ascertain if compliance is possible and practicable, or illusory Special Circumstances

i. Ground Leased Property: termination of ground lease
   • Borrower should carve out termination relating to borrower purchase of fee title – which lender should permit if deed of trust/mortgage has provision to spread to fee title upon borrower’s acquisition

ii. Lease termination – single tenant property
   • Lender may not want to foreclose on a vacant property with no income
d. Less Frequent Provisions
   i. Expand Bankruptcy, insolvency to filing by or against any principal of a borrower or guarantor (may go further upstream)
   ii. Any legal proceeding by borrower, a guarantor, affiliate or principal which interferes, delays or frustrates lender’s efforts to enforce rights under loan documents or otherwise relating to the collateral or loan
      o For example, see: Wells Fargo Bank, N.A. v RLJ Lodging Trust, 2016 WL 427487, ___ F. Supp. 3d ___ (N.D. Ill. 2/4/2016) where the Court denied a guarantor’s summary judgment motion and found the below quoted full recourse guaranty triggered when a borrower answered a foreclosure complaint, and its answer included denying allegations, asserting affirmative defenses and seeking an affirmative prayer for relief. The applicable guaranty’s text stated:
         [I]n the event…any Grantor or any Affiliate of any Grantor contests or materially interferes with, director or indirectly (collectively, a “Contest”), any foreclosure action, …whether by making any motion, bringing any counterclaim, claiming any defense, seeking any injunction or other restraint, commencing any action, or otherwise…then the Guaranteed Obligations shall also include the unpaid balance of the Debt...
         See, also, Tamach Airport Manager, LLC, v. HRC Fund III Pooling Dom. LLC, 603817/08, 2010 WL 2106221 (N.Y. Sup. May 10, 2010)(cited in RLJ Lodging Trust)(even where Borrower’s efforts to stop foreclosure sale ultimately unsuccessful, the commencing of litigation to halt a foreclosure sale nullified non-recourse nature of loan).
   iii. First full monthly payment amount is not paid when due
   iv. Borrower’s inability to rebuild improvements after a casualty or condemnation as substantially existed at closing, in compliance with applicable law
   v. Failure to pay taxes or insure – sometimes moved from damages/loss to springing full recourse
   vi. Property control issues: fails to permit lender inspections of property, fails to provide required financial information (see U.S. Bank N.A. v. Green Meadow SWS L.L.C, 9. N.E.3d 433 (Ohio App. 2014), fails to appoint new property manager (all of the foregoing should be set forth as lender rights in loan documents before guarantor agrees to put it here)

VIII. Side discussion on SPE Requirements
   a. Common requirement for CMBS loans. “An SPE is an entity, formed concurrently with or immediately prior to the subject transaction, that is unlikely to become insolvent as a result of its own activities and that is adequately insulated from the consequences of a related party’s insolvency.” Standard & Poor’s, US. CMBS Legal and Structured Finance Criteria, Section 3: Special-Purpose Bankruptcy-Remote Entities (May 1, 2013, republished December 9, 2011).

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3 Attribution for the SPE analysis in this section is given to Harriet “Beth” Alexson, Peter Munoz, Edward Wender, Bankruptcy Remoteness Non-Recourse Carve Outs Non-Consolidation and the Meaning of Life, presentation at ABA Business Law Section, Real Estate Financing Subcommittee Meeting, April 2016.
b. General purpose: insulate the borrower from being pulled into the bankruptcy case of its parent, affiliate or principals (either through substantive consolidation or joint administration)

c. SPE requirements usually hard coded both as covenants in loan documents and borrower’s entity documents

d. SPE requirements genesis is from bankruptcy substantive consolidation cases, quite similar to piercing corporate veil common law; do not want intermingling with affiliates business operations, assets or liabilities; do not want borrower propped up by its affiliates, nor propping them up, through sweetheart deals. Attached as Appendix 2 are two sets of SPE requirements; the first from a small non CMBS loan, the second from a recent CMBS loan. Every lender’s counsel has their own variations and care should be taken in reviewing the SPE requirements to confirm they apply to the deal at hand and can be performed by the borrower and guarantors.

f. Worrisome Covenants for Bad Boy Guarantors – since violations = springing full recourse liability

i. Paying debts and liabilities as they come due from borrower’s assets only – what is fall short?
   • Remain solvent or sufficiently capitalized – seems illusory since a loan default could be interpreted as insolvency, meaning the guaranty is really full recourse. This was the unfortunate result, in a commercial loan, the springing full recourse guaranty was triggered by failing to pay loan. In Wells Fargo Bank N.A. v Cherryland Mall L.P., 295 Mich. App. 799, 812 N.W.2d 79(2011) the SPE provision at issue required that the borrower not “become insolvent or fail to pay its debts from its assets as the same shall become due.” Id. At 123. When the borrower defaulting on paying the loan, the Court found a breach of the SPE provisions which, in turn, triggered full recourse under the guaranty.
   • For a discussion on the Cherryland Mall response and other potential defenses, see, generally, Penny L. Christophorou, Limited Recourse/Carve-out Guaranties and Bad Boy Provisions, Response to Cherryland Mall Case, ALI 2015: Commercial Lending Today.
   • **Drafting suggestion for borrowers:** Care to review all of the SPE requirements, if any violation triggers the full recourse guaranty consider if really a full recourse loan at the onset. If so, argue for limitations on the lack of capitalization, involuntary liens and insolvency provisions – if the borrower complies with the lender approved budget or the lender otherwise approves additional expenses (indebtedness), and project still underwater, then do not want full recourse liability triggered, but instead should only trigger the damages/loss guaranty liability to the extent such SPE violations cause the substantive consolidation of the borrower’s case with the bankruptcy of the borrower’s affiliate or principal.
IX. Other Guaranty Issues

a. Capped Guaranties
   i. Must be drafted carefully
   ii. Avoid use of terms “top” or “first” $ amount – creates an ambiguity and might be construed as paid off if borrower has paid a portion of the debt or if there has been a foreclosure with a deficiency remaining
   iii. Consider if part of a joint and several guaranty
   iv. Consider if cap does not limit certain recoveries
      o Attorney’s fees
      o Recovery under environmental indemnities
      o Carve Outs (particularly partial bad boy damages/loss guaranties)

b. Construction Guaranty
   i. Construction/Completion Guaranties
   ii. Case law split on whether a construction guaranty is a guaranty or indemnity, see, e.g., Chase Manhattan Bank, N.A. v American Nat. Bank & Trust Co. of Chicago, 93 F.3d 1064 (2d. Cir. 1996), compared to Turnberry Residential L.P. v Wilmington Trust FSB, 950 N.Y.S.2d 362 (2012).
   iii. Avoid ambiguity by using a direct indemnity instead
   iv. Consider what lender attempting to obtain, possibilities:
      • Cost to complete construction
      • Equity shortfall in constructing
      • Shortfall in value of collateral for failure to complete
      • When is it satisfied? CO? TI Completion?
      • Who controls construction?
      • If guarantor constructing, will lender fund balance of loan draws?

X. Guaranty Enforcement – Issues Concerning Bad Boy Carve-Outs
   (this discussion includes both partial recourse and full recourse carve-out guaranties)

   ii. Heller Financial v. Lee, 2002 WL 188591 (N.D. Ill. 2002). Full recourse covenant prohibiting the borrower from granting or allowing the filing of any lien or encumbrance on the project held to be enforceable and triggered by mechanic’s lien and tax liens recorded against the property. But see CP III Rincon Towers, Inc. v. Cohen, 13 F. Supp. 3d 307 (S.D. N.Y. 2014)(Appeal filed May 6, 2014) Full recourse covenant prohibiting the borrower from granting or allowing the filing of any voluntary lien not triggered by mechanic’s lien as mechanic’s lien determined not to be a voluntary lien.
iii. **G3-Purves Street, LLC v. Purves, 953 N.Y.S. 2d 109 (2012).** Full recourse covenant in guaranty agreement allowing full recourse liability due to borrower’s failure to pay taxes held to be enforceable and not a liquidated damage provision that imposed an unenforceable penalty.

iv. **In re Inn at Woodbridge, 2015 WL 1013585 (D. New Jersey 2015).** Full recourse covenant in guaranty agreement allowing for full recourse liability upon the bankruptcy filing of borrower held enforceable despite lender’s settlement with borrower.

v. **111 Debt Acquisition Holdings, LLC v. Six Ventures Ltd., 413 Fed Appx 824 (6th Cir. 2014) Not For Publication.** Full recourse covenant in guaranty agreement allowing full recourse liability upon the filing of a bankruptcy petition by or against, or “consented to or acquiesced in by” borrower or guarantors held to be enforceable when borrower filed for bankruptcy relief, even if a guarantor contested the bankruptcy filing.


b. Failed Defenses To Bad Boy Carve-Out Provisions
   i. Violates Public Policy;
   ii. Unreasonable Penalty;
   iii. Breach of the Implied Covenant of Good Faith and Fair Dealing; and
   iv. Actions Beyond Guarantors’ Control.

c. Possible Defenses To Bad Boy Carve-Out Provisions
   i. Materiality?
      o **Wells Fargo Bank, N.A., v. RLJ Lodging Trust, 2016 WL 427487 (N.D. Ill 2016).** Full recourse covenant in guaranty agreement allowing for full recourse liability should the guarantor contest or in any material way interfere with any foreclosure by lender. After borrower’s default, borrower offered to surrender real property but answered lender’s foreclosure complaint, denying certain allegations and alleging affirmative defenses. Summary judgment denied upon challenges to the term “material” and “contest.”
   ii. Careful Reading of Lease/Loan Documents –
      o **GECCMC 2005-C1 Plummer Street Office Limited Partnership v. NRFC NNN Holdings, LLC, 204 Cal App 4th 998 (2012).** Full recourse covenant in guaranty agreement guarantying $44 million loan and providing for full recourse upon termination of specified lease held to be enforceable, although not triggered by the provisions of the loan and lease documentation at issue in the case.

**XI. Guaranty Enforcement – Issues Concerning One Form of Action Rule**

a. What Is The One Form Of Action Rule?
   i. Pursuant to California Civil Code Section 726, the only remedy to enforce an obligation secured by real property is foreclosure. The one form of action rule does not apply to liens on personal property unless the debt is secured by both personal property and real property collateral.
   ii. Applies only to obligations secured by real property.
   iii. Definition of what is an “action” is unclear under state law.
b. Dual Components Of The One Form Of Action Rule:
i. Secured creditor must foreclose the security prior to any other action against the borrower and is violated if the secured creditor takes any other “action” for recovery of the secured debt without a foreclosure of the security (one action aspect); and

ii. The secured creditor cannot undertake an action without including all of the real property security of the debt (security first aspect).

c. Public Policy Concerns Underlying The One Form of Action Rule.
i. Avoid a multiplicity of actions filed against defaulting borrower.

ii. Compel competitive bidding at foreclosure to test the value of the security.

iii. Compel the secured creditor to look to the collateral as the primary source of repayment of the secured debt before looking to the other assets of the borrower.

iv. Credit the borrower with the fair market value of the secured property before possibly subjecting the borrower to personal liability.

d. Brief overview of judicial and non-judicial foreclosure.
i. Non-Judicial Foreclosure
(a) Recordation of notice of default;
(b) Publication of notice of sale.

ii. Judicial Foreclosure
(a) Judgment Permitting Judicial Foreclosure;
(b) Judicial Foreclosure;
(c) Fair Value Hearing;
(d) Deficiency Judgment

e. Relationship Between The One Form Of Action Rule And The Anti-Deficiency Statutes.
• The anti-deficiency statutes prohibit in many circumstances the ability of the lender recover any deficiency following foreclosure of an obligation secured by a deed of trust. The one form of action rule requires that the secured lender forecloses on an obligation secured by a deed of trust before taking any other action.

f. The Impact Of The One Form Of Action Rule And The Anti-Deficiency Statutes On A Guaranty Of A Real Property Secured Loan.
i. The one form of action rule does not affect a guaranty agreement that is not secured by real property, even if the loan guaranteed by the guarantor is secured by a deed of trust because a guaranty is a separate and distinct obligation from that of the loan. Although California law requires that a lender first seek recovery against its collateral and the borrower before proceeding against the guarantor, most guaranty agreements contain valid waivers of this requirement.

ii. The anti-deficiency statutes also do not impact the liability of a guarantor even though the guarantor’s right to subrogation as against the borrower may be eliminated, provided that the guaranty is not secured by real property and the guaranty agreement contains a valid waiver of such requirement. Thus, a lender may recover a deficiency judgment from a guarantor who waives his or her anti-deficiency protections, even though the anti-deficiency statutes would bar the lender from recovering that same deficiency from the primary borrower. However, to collect a deficiency from a
guarantor, the guarantor must be a true guarantor and not merely the principal debtor under a different name.

XII. SHAM GUARANTIES.

   i. The sham guaranty defense is used to disprove that a valid and enforceable guaranty exists and is typically raised when the lender seeks to obtain judgment on a guaranty following non-judicial foreclosure. A guaranty is a sham where the guarantor is the principal obligor on the debt, either because he or she personally executed the note or deed of trust, or because the guarantor is liable for the debts of the borrower by operation of some legal or equitable principle. Where there is legal separation between the borrower and guarantor, however, the guaranty is enforceable unless the loan transaction has been structured to subvert the anti-deficiency laws. Understanding the sham guaranty defense is critical because if a guarantor is successful in asserting this defense, it will be a complete defense and bar enforcement of the guaranty.

b. Sham Guaranty - Guarantor Is Directly Liable Under The Loan Documents
   i. Union Bank v. Dorn, 254 Cal. App. 2d 157 (1967). Guaranty is not enforceable because the guarantors were general partners of a general partnership.
   ii. Torrey Pines v. Hoffman, 231 Cal. App. 3d 308 (1991). Guaranty is not enforceable because the guarantors were the trustor, beneficiary and trustee of the revocable trust borrower. The defendant guarantors were determined to be nothing more than the principal obligors under another name.

c. Guarantor Is An Instrumentality Of The Borrower To Avoid The Anti-Deficiency Statutes
   i. Valinda Builders, Inc. v. Bissner, 230 Cal App 2d 106 (1964). The defendants guaranteed a loan taken out by their corporation, which was organized for the sole purpose of taking on the loan. The corporation had a paid-in capital of only $200, and the defendants and their wives were its only stockholders, directors, and officers. Relying on alter ego principles, the court concluded there was no evidence the corporation was anything other than “an instrumentality used by the individuals or that defendants were ever removed from their status and obligations of purchasers.” Thus, the alleged guaranty of defendants was no more than a promise to pay their own debt.
   ii. River Bank America v. Diller, 38 Cal. App. 4th 1400 (1995). In the River Bank case, the plaintiff tried to enforce guaranties executed by the defendants in connection with a loan made to a limited partnership of which the defendants’ corporation was the general partner. The court reversed the trial court’s grant of summary judgment in favor of the lender.
   - The River Bank court decided that the borrower had raised a triable issue of fact as to whether the lender structured the transaction to avoid the purpose of the anti-deficiency laws based on evidence that the lender relied on extensive financial statements from the guarantors but never inquired about the financial standing of the borrower. The River Bank court also concluded the “purpose and effect” of the agreements was pertinent, since there was evidence that the lender required the borrower to be a limited partnership and insisted that one of the defendants be removed as general partner so it could be replaced with a shell corporation. Thus, according to the River Bank court, the lender
“subverted” the purposes of the anti-deficiency laws by imposing specific directives on the loan to the principal obligor. The River Bank court held it was not conclusive that the general partner was a long-standing corporation that adhered to all formalities or that the debt did not directly obligate the corporation’s shareholders and officers, reasoning that the lender structured the transaction to relegate the obligors to the position of guarantors.

iii. CADC/RAD Venture 2011-1 LLC v. Bradley, 235 Cal App 4th 775 (2015). Reversing the jury decision of the trial court in favor of the guarantors, the CADC/RAD court found that enforcement of the guaranty was equitable even though the lender looked only to the guarantors to maintain the loan and did not even review the financial information of the borrower. Of utmost importance to the CADC/RAD court was that the borrower and guarantors designed the structure of the loan transaction. Therefore, since the lender did not structure the loan transaction to deprive the guarantor of the protections of the California anti-deficiency statutes as in the River Bank decision, the CADC/RAD court held that the guaranties were enforceable.
APPENDIX 1
SAMPLE SURETYSHIP DEFENSE WAIVER

(a) Lack of diligence or any delays in collecting or enforcing the Loan Documents;
(b) The failure or invalidity of, or any defect in, the Loan Documents;
(c) Any disability or other defense of the Borrower, or any other guarantor, or any other person;
(d) The termination from any cause whatsoever of any of the obligations under the Loan Documents, except upon satisfaction of all of the Guaranteed Obligations, including payment in full of all of the Indebtedness and satisfaction of all of Borrower’s other obligations under the Loan Documents;
(e) The loss or impairment of any right of recourse, reimbursement, contribution, subrogation, or any other right or remedy of any Guarantor against Borrower, any other guarantor, or any other person to recover amounts which Guarantor is obligated to pay under this Guaranty;
(f) Any modification of any of the terms and conditions of the Loan Documents in any form whatsoever, and without notice to any Guarantor, including the renewal, extension, compromise, acceleration, or other change in time for payment or performance thereof and any increase or decrease in the rate of interest thereon;
(g) Lender’s foreclosure of the Collateral or any portion thereof; it being intended that this Guaranty will survive the realization upon any of the Collateral, including by nonjudicial foreclosure. Such waiver will include any defense, right, or claim that any such foreclosure satisfied the obligations secured thereby pursuant to [insert non-judicial foreclosure statute], as amended or such successor statutes; and
(h) Any right to demand a trial by jury in any proceeding relating to this Guaranty.

[i] IN CALIFORNIA ADD: Further, each Guarantor hereby waives any defense based on any of the following:
(i) Any rights of Guarantor of subrogation, reimbursement, indemnification, and/or contribution against Borrower or any other person or entity, and any other rights and defenses that are or may become available to Guarantor or any other person or entity by reasons of Sections 2787 - 2855, inclusive of the California Civil Code;
(ii) All rights and defenses arising out of any election of remedies by Lender even though that election of remedies, such as a nonjudicial foreclosure with respect to the security for the Guaranteed Obligations, has destroyed the Guarantor’s rights of subrogation and reimbursement against Borrower by the
operation of Section 580d of the California Code of Civil Procedure or any similar law of California or of any other State or of the United States; and

(iii) All rights and defenses that Guarantor may have because the Guaranteed Obligations are secured by real property or any estate for years. These rights or defenses include, but are not limited to, any rights or defenses that are based upon, directly or indirectly, the application of Section 580a, Section 580b, Section 580d or Section 726 of the California Code of Civil Procedure.

(iv) The provisions of this subsection (c) mean, among other things:

(v) Lender may collect from Guarantor without first foreclosing on any real or personal property collateral pledged by Borrower for the Loan; and

(vi) If Lender forecloses on real property collateral pledged by Borrower:

(vii) The Guaranteed Obligations may be reduced only by the price for which such real property collateral is sold at the foreclosure sale, even if such real property collateral is worth more than the sale price; and

(viii) The Lender may collect from the Guarantor even if the Lender, by foreclosing on the real property collateral, has destroyed any right the Guarantor may have to collect from the Borrower.

The foregoing is an unconditional and irrevocable waiver of any rights and defenses each Guarantor may have because Borrower’s obligations are secured by real property. These rights and defenses, include, but are not limited to, any rights or defenses based upon Section 580a, Section 580b, Section 580d or Section 726 of the California Code of Civil Procedure.]
APPENDIX 2

STANDARD SPE REQUIREMENTS

I. From a smaller, non-CMBS 2015 Loan-similar text should be in both the loan agreement and also the Borrower’s governing document (e.g. LLC Operating Agreement):

(i) The Borrower will not:
- engage in any business or activity other than the ownership, operation and maintenance of the Property, and activities incidental thereto;
- acquire or own any assets other than (a) the Property, and (b) such incidental personal property as may be necessary for the ownership, leasing, maintenance and operation of the Property;
- merge into or consolidate with any person, or dissolve, terminate, liquidate in whole or in part, transfer or otherwise dispose of all or substantially all of its assets or change its legal structure;
- fail to observe all organizational formalities, or fail to preserve its existence as an entity duly organized, validly existing and in good standing (if applicable) under the applicable legal requirements of the jurisdiction of its organization or formation, or amend, modify, terminate or fail to comply with the provisions of its organizational documents;
- own any subsidiary, or make any investment in, any person;
- commingle its funds or assets with the funds or assets of any other person;
- fail to maintain all of its books, records, financial statements and bank accounts separate from those of any other person (including, without limitation, any Affiliates). The Borrower’s assets have not and will not be listed as assets on the financial statement of any other person; provided, however, that the Borrower’s assets may be included in a consolidated financial statement of its Affiliates provided that (a) appropriate notation shall be made on such consolidated financial statements to indicate the separateness of the Borrower and such Affiliates and to indicate that the Borrower assets and credit are not available to satisfy the debts and other obligations of such Affiliates or any other person and (b) such assets shall be listed on the Borrower’s own separate balance sheet. The Borrower has maintained and will maintain its books, records, resolutions and agreements as official records;
- assume or guaranty the debts of any other person, hold itself out to be responsible for the debts of any other person, or otherwise pledge its assets for the benefit of any other person or hold out its credit as being available to satisfy the obligations of any other person;
- make any loans or advances to any person;
- fail to (a) hold itself out to the public and identify itself, in each case, as a legal entity separate and distinct from any other person and not as a division or part of any other person, (b) conduct its business solely in its own name, (c) hold its assets in its own name or (d) correct any known misunderstanding regarding its separate identity;
- make any dividend or distribution to its partners, members, managers, shareholders or directors, as applicable, if doing so would cause it to become insolvent or to fail to maintain adequate capital for the normal obligations reasonably foreseeable in a business of its size and character and in light of its contemplated business operations,
provided, however, that the foregoing shall not be deemed to require any partner, member, manager, shareholder or director to make any capital contribution or other equity investment;

- undertake any of the following without the prior unanimous written consent of all of its partners, members, managers, shareholders or directors, as applicable: (a) file or consent to the filing of any petition, either voluntary or involuntary, to take advantage of any Creditors’ Rights Laws, (b) seek or consent to the appointment of a receiver, liquidator or any similar official, (c) take any action that might cause such entity to become insolvent, or (d) make an assignment for the benefit of creditors;
- fail to allocate shared expenses (including, without limitation, shared office space) or fail to use separate stationery, invoices and checks with its own name;
- acquire obligations or securities of its partners, members, managers, shareholders, directors or other Affiliates, as applicable;
- identify its partners, members, managers, shareholders, directors or other Affiliates, as applicable, as a division or part of it; or
- maintain its assets in a way difficult to segregate and identify.

(ii) As long as any portion of the Loan remains outstanding, the Borrower will not:

- dissolve, merge, liquidate or consolidate;
- except in connection with a sale or other transfer permitted under the Loan Documents, sell all or substantially all of its assets; or
- amend [the SPE Section of LLC agreement] without the consent of Lender.

(iii) As used in herein the capitalized terms are defined as follows:

- “Affiliate” of a Person means: (A) any officer, partner, director, manager, trustee, member, or controlling shareholder of such Person; (B) any Person controlling, controlled by or under common control with such Person; and (C) any officer, partner, director, manager, trustee, member, or controlling shareholder of any Person described in (B) above. For purposes of this definition, the term “control” shall mean the power to direct the management and policies of such Person, directly or indirectly, by or through stock ownership, agency or otherwise, or pursuant to or in connection with an agreement, arrangement or understanding (written or oral) with one or more other Persons by or through stock ownership, agency or otherwise; and the terms “affiliated”, “controlling” and “controlled” shall have meanings correlative to the foregoing.
- “Person” means any individual, general partnership, limited partnership, limited liability company, limited liability partnership, corporation, trust, estate, real estate investment trust, association, or other entity.

(iv) Standards Governing Actions. To the fullest extent permitted by applicable law, the members shall at all times take into account the interests of the Borrower’s creditors as well as the interests of its members in connection with all matters subject to the consideration or vote of the members.

(v) Office. The Borrower will establish and maintain an office through which its business shall be conducted separate and apart from that of any of its Affiliates or Person and shall allocate fairly and reasonably any overhead for shared office space.
(vi) Payment. The Borrower will pay any liabilities out of its own funds, including salaries of any employees, not funds of any Affiliate or any Person.

(vii) Arm’s Length. The Borrower will maintain an arm’s length relationship with any Affiliate or Person.

II. From a 2015 CMBS Loan (large loan) - similar text should be in both the loan agreement and also the Borrower’s governing document (e.g. LLC Operating Agreement):

(i) Borrower Will not do any of the following [until all obligations under Loan Documents satisfied in full and Deed of Trust reconveyed]:

- engage in any business or activity unrelated to the acquiring, developing, owning, holding, selling, leasing, transferring, exchanging, financing, managing, operating and maintaining the Property, and activities incidental thereto;

- acquire or own any assets other than (A) the Property, and (B) such incidental Personal Property as may be necessary for developing, owning, holding, selling, leasing, transferring, exchanging, financing, managing, operating and maintaining the Property;

- merge into or consolidate with any Person, or dissolve, terminate, liquidate in whole or in part, transfer or otherwise dispose of all or substantially all of its assets or change its legal structure;

- to the fullest extent permitted by law, engage in, seek or consent to, (A) any dissolution, winding up, liquidation, consolidation or merger, (B) except as permitted under the terms of this Agreement, any transfer of partnership or membership interests (if such entity is a general partner in a limited partnership or a member in a limited liability company), or (iii) any amendment of its limited partnership agreement, articles of incorporation, articles or organization, certificate of formation or operating agreement (as applicable) with respect to the matters set forth in this Section without the written consent of Lender;

- fail to observe all organizational formalities, or fail to preserve its existence as an entity duly organized, validly existing and in good standing (if applicable) under the applicable Legal Requirements of the jurisdiction of its organization or formation and, if applicable, qualified in the jurisdiction where the Property is located, or amend or modify its organizational documents to amend or modify the provisions of this Section as set forth in such organizational documents, or terminate or fail to comply with the provisions of its organizational documents;

- own any subsidiary, or make any investment in, any Person (other than, with respect to any SPE Component Entity, in Borrower);

- commingle its funds or assets with the funds or assets of any other Person;
• incur any Indebtedness, secured or unsecured, direct or contingent (including guaranteeing any obligation), other than (A) the Debt, (B) trade and operational indebtedness (including, without limitation, Permitted Equipment Leases) incurred in the ordinary course of business (provided such indebtedness is unsecured) relating to the ownership and operation of the Property and the routine administration of Borrower, in amounts not to exceed two percent (2%) of the outstanding principal amount of the Debt, which liabilities are not due more than sixty (60) days past the date incurred, are not evidenced by a note and are paid within sixty (60) days of when due (unless the payment thereof within such sixty (60) day period cannot be made because of the absence of cash flow or, to the extent the intended source of such payment is an Additional Advance or disbursement from an applicable Reserve Account, the failure of Lender to disburse an Additional Advance or funds from an applicable Reserve Account in breach of this Agreement), and which are normal and reasonable under the circumstances, (C) non-delinquent property taxes and assessments (unless the payment thereof cannot be made because of the absence of cash flow or, to the extent the intended source of such payment is an Additional Advance or disbursement from an applicable Reserve Account, the failure of Lender to disburse an Additional Advance or funds from the applicable Reserve Account in breach of this Agreement), and (D) indebtedness otherwise expressly permitted by this Agreement or which is approved in writing by Lender (if Lender’s approval thereof is required pursuant to the terms hereof), which approval may be granted or withheld in Lender’s sole and absolute discretion (except as otherwise set forth herein) (collectively “Permitted Indebtedness”); provided, however, the foregoing shall not require any direct or indirect owner, member or partner to make any additional capital contributions or advance any funds to such Person or prohibit capital contributions and distributions permitted under the terms and conditions of the Loan Documents and Borrower’s organizational documents and applicable law and properly reflected in the books and records of Borrower. No Indebtedness other than the Debt may be secured (subordinate or pari passu) by the Property;

• fail to maintain all of its books, records, financial statements and bank accounts separate from those of any other Person (including, without limitation, any Affiliates). Borrower’s assets have not and will not be listed as assets on the financial statement of any other Person; provided, however, that Borrower’s assets have been and may be included in a consolidated financial statement of its Affiliates provided that (A) appropriate notation shall be made on such consolidated financial statements to indicate that Borrower’s assets are owned by Borrower and (B) such assets shall be listed on Borrower’s own separate balance sheet. Borrower has maintained and will maintain its books, records, resolutions and agreements as official records;

• enter into any contract or agreement with any general partner, member, shareholder, principal or Affiliate, except upon terms and conditions that are intrinsically fair and substantially similar to those that would be available on an arm’s-length basis with unaffiliated third parties;

• maintain its assets in such a manner that it will be costly or difficult to segregate, ascertain or identify its individual assets from those of any other Person;
• assume or guaranty the debts of any other Person, hold itself out to be responsible for the debts of any other Person, or otherwise pledge its assets for the benefit of any other Person or hold out its credit as being available to satisfy the obligations of any other Person;

• make any loans or advances to any Person;

• fail to file its own tax returns, except to the extent that it is treated as a “disregarded entity” or part of a consolidated group for federal or state income tax purpose and is not required to file federal or state income tax returns under applicable Legal Requirements;

• fail to (A) hold itself out to the public and identify itself, in each case, as a legal entity separate and distinct from any other Person and not as a division or part of any other Person, (B) conduct its business solely in its own name, (C) hold its assets in its own name or (D) correct any known misunderstanding regarding its separate identity;

• fail to maintain adequate capital for the normal obligations reasonably foreseeable in a business of its size and character and in light of its contemplated business operations (to the extent there exists sufficient cash flow from the Property to do so); provided, however, the foregoing shall not require any direct or indirect owner, member or partner to make any additional capital contributions or advance any funds to such Person or prohibit capital contributions and distributions permitted under the terms and conditions of this Agreement and Borrower’s organizational documents and applicable law and properly reflected in the books and records of Borrower;

• without the prior unanimous written consent of all of its partners or members, as applicable, and the prior written consent of the Independent Director, (A) file or consent to the filing of any petition, either voluntary or involuntary, to take advantage of any Creditor’s Rights Laws, (B) seek or consent to the appointment of a receiver, liquidator or any similar official, or (C) make an assignment for the benefit of creditors;

• fail to allocate shared expenses (including, without limitation, shared office space) or (B) fail to use separate stationery, invoices and checks bearing its name (or the name of an entity designated as being Borrower’s agent) or the name of the Property;

• fail to pay its own liabilities (including, without limitation, salaries of its own employees (if any)) from its own funds or fail to maintain a sufficient number of employees (if any) in light of its contemplated business operations (in each case to the extent there exists sufficient cash flow from the Property (or funds from the designated sources for such payments pursuant to the terms of this Agreement) to do so and such cash flow (or funds) is made available to Borrower); provided, however, the foregoing shall not require any direct or indirect owner, member or partner to make any additional capital contributions or advance any funds to such Person;

• acquire obligations or securities of its partners, members, shareholders or other Affiliates, as applicable; or
• identify its partners, members, shareholders or other Affiliates, as applicable, as a division or part of it.

(ii) For so long as Borrower is an Acceptable LLC, the limited liability company agreement of Borrower (the “LLC Agreement”) shall provide that (i) upon the occurrence of any event that causes the last remaining member of Borrower (“Member”) to cease to be the member of Borrower (other than (A) upon an assignment by Member of all of its limited liability company interest in Borrower and the admission of the transferee in accordance with the Loan Documents and the LLC Agreement, or (B) the resignation of Member and the admission of an additional member of Borrower in accordance with the terms of the Loan Documents and the LLC Agreement), any person acting as Independent Director of Borrower shall, without any action of any other Person and simultaneously with the Member ceasing to be the member of Borrower, automatically be admitted to Borrower as a member with a 0% economic interest (“Special Member”) and shall continue Borrower without dissolution and (ii) Special Member may not resign from Borrower or transfer its rights as Special Member unless (A) a successor Special Member has been admitted to Borrower as a Special Member in accordance with [Delaware] law (as applicable) and (B) after giving effect to such resignation or transfer, there remains at least one (1) Independent Director of the Borrower in accordance with Section _____ below. The LLC Agreement shall further provide that (i) Special Member shall automatically cease to be a member of Borrower upon the admission to Borrower, of the first substitute member, (ii) Special Member shall be a member of Borrower that has no interest in the profits, losses and capital of Borrower and has no right to receive any distributions of the assets of Borrower, (iii) pursuant to the applicable provisions of the limited liability company act of the State of [Delaware] (the “Act”), Special Member shall not be required to make any capital contributions to Borrower and shall not receive a limited liability company interest in Borrower, (iv) Special Member, in its capacity as Special Member, may not bind Borrower and (v) except as required by any mandatory provision of the Act, Special Member, in its capacity as Special Member, shall have no right to vote on, approve or otherwise consent to any action by, or matter relating to, Borrower including, without limitation, the merger, consolidation or conversion of Borrower; provided, however, such prohibition shall not limit the obligations of Special Member, in its capacity as Independent Director, to vote on such matters required by the Loan Documents or the LLC Agreement. In order to implement the admission to Borrower of Special Member, Special Member shall execute a counterpart to the LLC Agreement. Prior to its admission to Borrower as Special Member, Special Member shall not be a member of Borrower or any SPE Component Entity (as applicable), but Special Member may serve as an Independent Director of Borrower.

(iii) The LLC Agreement shall further provide that for so long as the Debt remains outstanding: (i) upon the occurrence of any event that causes the Member to cease to be a member of Borrower to the fullest extent permitted by law, the personal representative of Member shall, within ninety (90) days after the occurrence of the event that terminated the continued membership of Member in Borrower, agree in writing (A) to continue Borrower and
(iv) to the admission of the personal representative or its nominee or designee, as the case may be, as a substitute member of Borrower effective as of the occurrence of the event that terminated the continued membership of Member in Borrower, (ii) any action initiated by or brought against Member or Special Member under any Creditor’s Rights Laws shall not cause Member or Special Member to cease to be a member of Borrower and upon the occurrence of such an event, the business of Borrower shall continue without dissolution and (iii) each of Member and Special Member waives any right it might have to agree in writing to dissolve Borrower upon the occurrence of any action initiated by or brought against Member or Special Member under any Creditor’s Rights Laws, or the occurrence of an event that causes Member or Special Member to cease to be a member of Borrower.

(v) If Borrower is a partnership or limited liability company (other than an Acceptable LLC), each general partner (in the case of a partnership) and at least one member (in the case of a limited liability company) of Borrower, as applicable, shall be a corporation or an Acceptable LLC (each an “SPE Component Entity”) whose sole asset is its interest in Borrower. Each SPE Component Entity (i) will at all times comply with each of the covenants, terms and provisions contained in Section 5.1(a)(iii) – (vi) (inclusive) and (viii) – (xx) (inclusive) and, if such SPE Component Entity is an Acceptable LLC, Section 5.1(c) and (d) hereof, as if such representation, warranty or covenant was made directly by such SPE Component Entity; (ii) will not engage in any business or activity other than owning an interest in Borrower; (iii) will not acquire or own any assets other than its partnership, membership, or other equity interest in Borrower; (iv) will at all times continue to own no less than a 0.5% direct equity ownership interest in Borrower; (v) will not incur any debt, secured or unsecured, direct or contingent (including guaranteeing any obligation); and (vi) will cause Borrower to comply with the provisions of this Section 5.1.

(vi) Independent Director.

(a) The organizational documents of Borrower (to the extent Borrower is a corporation or an Acceptable LLC), as applicable, shall provide that at all times there shall be at least one (1) duly appointed independent director or manager (an “Independent Director”) who shall (I) not have been at the time of each such individual’s initial appointment, and shall not have been at any time during the preceding five (5) years, and shall not be at any time while serving as Independent Director, either (i) a shareholder (or other equity owner) of, or an officer, director (other than in its capacity as Independent Director), partner, member or employee of, Borrower or any of its respective shareholders, partners, members, subsidiaries or Affiliates, (ii) a customer of, or supplier to, or other Person who derives any of its purchases or revenues from its activities with, Borrower or any of its respective shareholders, partners, members, subsidiaries or Affiliates, (iii) a Person who Controls or is under common Control with any such shareholder, officer, director, partner, member, employee supplier, customer or other Person, or (iv) a member of the immediate family of any such shareholder, officer, director, partner, member, employee, supplier, customer or other Person, (II) shall have, at the time of their appointment, had at least three (3) years’ experience in serving as an independent director and
(b) The organizational documents of Borrower shall further provide that (I) the board of directors, managing member or manager(s) of Borrower and its constituent equity owners (such constituent equity owners, the “Constituent Members”) shall not take any action which, under the terms of any organizational documents of Borrower, requires a unanimous vote of the board of directors or managers of Borrower or the Constituent Members and the prior written consent of the Independent Director as set forth herein unless at the time of such action there shall be at least one (1) Independent Director engaged as provided by the terms hereof; (II) any resignation, removal or replacement of any Independent Director shall not be effective without: (1) prior written notice to Lender and, if a Securitization has occurred, the Rating Agencies (which such prior written notice must be given on the earlier of five (5) days or three (3) Business Days prior to the applicable resignation, removal or replacement) and (2) evidence that the replacement Independent Director satisfies the applicable terms and conditions hereof and of the applicable organizational documents (which such evidence must accompany the aforementioned notice); (III) to the fullest extent permitted by applicable law, including Section 18-1101(c) of the Act and notwithstanding any duty otherwise existing at law or in equity, the Independent Director shall consider only the interests of the Constituent Members and Borrower (including Borrower’s creditors) in acting or otherwise voting on the matters provided for herein and in Borrower’s organizational documents (which such fiduciary duties to the Constituent Members and Borrower (including Borrower’s creditors), in each case, shall be deemed to apply solely to the extent of their economic interests in Borrower exclusive of (x) all other interests (including, without limitation, all other interests of the Constituent Members), (y) the interests of other Affiliates of the Constituent Members and Borrower and (z) the interests of any group of Affiliates of which the Constituent Members or Borrower is a part); (IV) other than as provided in Subsection (III) above, the Independent Director shall not have any fiduciary duties to any Constituent Members, any directors of Borrower or any other Person; (V) the foregoing shall not eliminate the implied contractual covenant of good faith and fair dealing under applicable law; and (VI) to the fullest extent permitted by applicable law, including Section 18-1101(e) of the Act, an Independent Director shall not be liable to Borrower, any Constituent Member or any other Person for breach of contract or breach of duties (including fiduciary duties), unless the Independent Director acted in bad faith or engaged in willful misconduct.

(vii) Change of Name, Identity or Structure. Borrower shall not change (or permit to be changed) Borrower’s or any SPE Component Entity’s (a) name, (b) identity (including its trade name or names), (c) principal place of business set forth on the first page of this Agreement or, (d) if not an individual, Borrower’s or any SPE Component Entity’s corporate, partnership or other structure, without notifying Lender of such change in writing at least thirty (30) days prior to the effective date of such change and, in the case of a change in Borrower’s or any SPE Component Entity’s structure, without first
obtaining the prior written consent of Lender and, if required by Lender, a Rating Agency Confirmation with respect thereto. Borrower shall execute and deliver to Lender, prior to or contemporaneously with the effective date of any such change, any financing statement or financing statement change required by Lender to establish or maintain the validity, perfection and priority of the security interest granted herein. At the request of Lender, Borrower shall execute a certificate in form satisfactory to Lender listing the trade names under which Borrower or any SPE Component Entity intends to operate the Property, and representing and warranting that Borrower or any SPE Component Entity does business under no other trade name with respect to the Property.

(viii) Business and Operations. Borrower will continue to engage in the businesses now conducted by it as and to the extent the same are necessary for the ownership, maintenance, management and operation of the Property. Borrower will qualify to do business and will remain in good standing under the laws of the jurisdiction as and to the extent the same are required for the ownership, maintenance, management and operation of the Property.
Guarantees, Indemnities, Non-Recourse Mortgages & Carve-Out Clauses: A Canadian Perspective

(“Toto, we’re definitely not in Kansas anymore!”)

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Guarantees and indemnities are frequently used in Canadian commercial mortgage loan transactions to provide additional assurance to a lender that a debt will be repaid. This paper gives a brief overview of the basics of guarantees and indemnities, discusses guarantees in the context of non-recourse mortgages, and highlights some of the key issues in drafting, negotiation and enforcement.

A. Mortgage Loans, Guarantees and Indemnities

There are two basic principles of a commercial mortgage. Firstly, it is a promise by the borrower to repay the principal amount to the lender in accordance with the terms set out in the mortgage. Secondly, it provides the lender with a secured interest in the property, which includes the associated remedies set out in the mortgage in the event that the borrower defaults.

A “true” guarantee is a secondary obligation that is only enforceable if a valid primary debt obligation exists. In the context of a commercial mortgage loan, the borrower remains primarily liable, while under a “true” guarantee, the guarantor assumes a secondary liability for the performance of the borrower’s obligations. There are several defences to a “true” guarantee, some of which are discussed below.

In contrast to a guarantee, an indemnity is a primary obligation in which the indemnifier will remain liable to the lender regardless of whether the principal obligation is or is not enforceable. Under an indemnity, the indemnifier assumes an independent responsibility to perform the obligations of the borrower, whether or not the borrower performs or defaults on those obligations. While the document may be called a “guarantee”, in almost all commercial mortgage documents the guarantee provisions create a primary obligation which acts as an

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1 This paper reflects Ontario law. The laws of the other common law provinces are similar. However, Quebec is a civil law, not common law, jurisdiction so different law applies except in the case of federally regulated areas such as bankruptcy.
indemnity in law. For consistency, this paper will use the term “guarantee” throughout to mean a true guarantee and/or an indemnity.  

B. Guarantee vs. Indemnity vs. Surety

As gleaned from the above description, the main difference between a guarantee and an indemnity is the nature of the obligation. As described by the Supreme Court of Canada in Communities Economic Development Fund v Canadian Pickles Corp:

Contracts of guarantee are sometimes distinguished from contracts of indemnity. In a contract of indemnity, the indemnifier assumes a primary obligation to repay the debt, and is liable regardless of the liability of the principal debtor. An indemnifier will accordingly be liable even if the principal debt is void or otherwise unenforceable. The distinction between contracts of guarantee and of indemnity ought not to be overemphasized. The resolution of a given case will turn on the correct interpretation of the contract and of the intention of the parties; attempts to label the contract as one of guarantee or of indemnity may be less than helpful.

In short, if the agreement provides that the promisor will pay only if a third party does not, then the agreement is a guarantee; whereas if the promisor is liable to pay in any event, then the agreement is an indemnity.

Several commentators in the United States have drawn a distinction between a surety and a guarantor. They argue that a surety is primarily or originally liable directly to the creditor under the same contract as the principal. In contrast, a contract of guarantee is a separate or collateral contract, and the guarantor's liability arises through and is contingent upon the liability of the principal debtor. Under Canadian law, surety and guarantor are used interchangeably and the distinction in terminology makes no difference. Furthermore, Ontario courts have held that sureties are guarantors who agree to be personally responsible to pay the amount specified if the principal fails to.

C. Guarantee of Debt or a Mortgage

(a) Structuring a Guarantee

When structuring a guarantee, it must be determined whether the guarantor is guaranteeing the debts of the borrower or guaranteeing the mortgage. If guaranteeing a debt, the guarantee will be an ‘all accounts’ guarantee. An all accounts guarantee is typically used where there are ongoing advances on a variety of loan facilities. In contrast, if the guarantee is for a mortgage loan, the guarantee may be included within the mortgage itself. A guarantee that protects a single fully advanced debt, such as a mortgage, is called a specific guarantee.

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2 The terms “guarantee” and “indemnity” will be used separately if the distinction is relevant. It is important to note that the terms have slightly different meanings in Canada and are interpreted differently than in the United States.

3 Communities Economic Development Fund v Canadian Pickles Corp, [1991] 3 SCR 388 (SCC) [Canadian Pickles].

4 Ibid at 413-14.

5 Abakhan v Halpen, 2008 BCCA 29 at para 19.

6 R v Dodson, 2000 CarswellOnt 49 (CA) at para 10.
(b) Guarantee Language and Standard Charge Terms

It is important for the drafters and negotiators of guarantees to consider the language that is used in the agreement. Guarantee language is often found in standard charge terms that are incorporated by reference into mortgages in Ontario. As a result, there may be instances where a separate guarantee agreement and the standard charge term provisions relating to guarantees conflict with one another. In situations where this occurs, section 9(4) of the *Land Registration Reform Act*\(^7\) provides that:

9(4) Where there is a conflict between an express term in a charge and a term deemed to be included in the charge by subsection (1), the express term prevails.\(^8\)

The Ontario Court of Appeal also gave effect to section 9(4) of the *Land Registration Reform Act*, by holding in *Royal Trust Corp of Canada v 502759*\(^9\) that:

Section 9(4) is a provision of general application. It is a statutory rule of interpretation that is triggered when a charge contains an express term that conflicts with a standard term. To the extent that the two terms are irreconcilable, s. 9(4) dictates that the express term prevails.\(^10\)

As a consequence of the judicial interpretation of section 9(4), drafters and negotiators of guarantees must pay strict attention to the language of the express terms as they may prevail over a standard charge term incorporated into the mortgage.

(c) Common Law Defences to consider when Drafting or Negotiating a Guarantee

When drafting or negotiating a guarantee, it is also important to consider the common law defences to the enforcement of a guarantee. Since a guarantee is simply a type of contract, defences ordinarily available to breach of contract claims are available to a guarantor such as, lack of consideration, duress, undue influence, *non est factum*, and material alteration.

(i) Lack of Consideration

As a contractual obligation, a guarantee must be supported by consideration.\(^11\) Consideration for a promise can consist of: (a) a benefit conferred on the other contracting party; (b) a benefit conferred on a third party; or (c) a detriment suffered.\(^12\) The consideration in support of a guarantee is open-ended and is valid as long as the consideration has legal value. Although the consideration may benefit the guarantor directly, it is not necessary that it do so.\(^13\)

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\(^{7}\) *Land Registration Reform Act*, RSO 1990, c L4.

\(^{8}\) *Ibid* at s 9(4).

\(^{9}\) *Royal Trust Corp of Canada v 502759*, 2000 CarswellOnt 2198 (CA).

\(^{10}\) *Ibid* at para 38.

\(^{11}\) *Manufacturers & Traders Trust Co v Amlinger*, 2006 CarswellOnt 5238 (Sup Ct) at paras 33-35.

\(^{12}\) *Ibid* at para 33.

\(^{13}\) *Bank of Montreal v 1480863 Ontario Inc*, 2007 CarswellOnt 2419 (Sup Ct) at para 35.
(ii) **Duress**

A guarantee which is (or, at least, originally was) otherwise enforceable may be rescinded by the guarantor where it was obtained as a result of duress to which the creditor was privy.\(^{14}\) If a contract is obtained by duress it is voidable. A contracting party may have the contract set aside if he or she shows that other contracting party exerted "coercive, unfair, or excessive pressure that overcame the consent or free will necessary to enter into a binding contract."\(^{15}\)

(iii) **Undue Influence and Spousal Relationships**

Where one party is subject to the undue influence of the other, an obligation lies to ensure that informed and independent advice is given to the guarantor, or at the very least, to ensure that the guarantor was advised to obtain such advice.\(^{16}\)

In a spousal relationship in Canada there is no presumption of undue influence.\(^{17}\) In the absence of any evidence for undue influence, fraud, or other vitiating factor, failure of the creditor to ensure that a spouse-guarantor has obtained independent legal advice before signing the guarantee is not fatal to a claim by the creditor.\(^{18}\) Some U.S. commentators have said that spousal guarantees are not valid when the asset is not needed as part of the asset base for credit approval. Subject to considerations of illegality, under Canadian law there is no legal restriction upon the extent to which one person may guarantee the debt, default or miscarriage of another person.\(^{19}\)

(iv) **Non est factum**

For a successful defence of non est factum (Latin for "it is not [my] deed"), the defendant must prove that he or she did not know the actual contents or character of the document that he or she signed.\(^{20}\) In addition, the contents of the document which the person signed must be radically and fundamentally different from the characteristics of the type of document the person believed they were signing.\(^{21}\) A mere misunderstanding of the scope of the guarantee is not sufficient to give rise to a defence of non est factum.\(^{22}\)

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\(^{15}\) DLG & Associates Ltd v Minto Properties Inc, 2014 ONSC 7287 at para 98. A great example of economic duress is found in *Process Automation Inc v Norstream Intertec Inc*, 2010 ONSC 3987 where the defendant coerced the plaintiff into signing a second contract purporting to reduce amount owed to plaintiff under the terms of the first contract.


\(^{17}\) Bank of Montreal v Featherstone, [1989] OJ No 613, 68 OR (2d) 541 at 547 (Ont CA).

\(^{18}\) Ibid.

\(^{19}\) Victoria-Vancouver Stevedoring Co v Grand Trunk Pacific Coast Steamship Co, [1918] 57 SCR 124.

\(^{20}\) Horvath v Young, [1980] OJ No 1185, 15 RPR 266 (Ont HCJ) at paras 35-36.


(v) **Material Alteration**

The focus of most guarantee litigation is the concept of ‘material alteration’. Unless the guarantee states otherwise, a guarantor will be released from liability in circumstances where the lender and the borrower agree to a material alteration of the terms of the loan, such as an increase in the rate of interest or terms for repayment, without the consent of the guarantor.23

(d) **Contracting Out of Common Law Defences**

It is well-established that parties to a guarantee are free to contract out of common law defences which would otherwise apply.24 In *Conlin*, the Supreme Court of Canada summarized several principles of interpretation applicable to contracting out of guarantees:

(i) any contracting out of a guarantor's protection against a material alteration of the terms of the contract of debt without his consent must be clear;

(ii) whether the guarantor contracted out of those protections must be determined by an interpretation of the clauses of the agreement, through a consideration of the transaction as a whole, and the application of the appropriate rules of construction;

(iii) any ambiguity in the terms used in the guarantee should be construed against the party which drafted it by applying the contra proferentem rule;

(iv) if there is a doubt or ambiguity as to the construction or meaning of the clauses binding the guarantor, they must be strictly interpreted and resolved in favour of the guarantor; and

(v) the clauses binding guarantors must be strictly construed.25

These principles have recently been applied in Ontario courts.26 In *Samson*, the Ontario Court of Appeal held that, “despite the material alterations in the underlying loan arrangements, [the guarantor’s] personal guarantee remains enforceable given the clear and unambiguous language of the guarantee and the factual context.”27 In this case, the first paragraph of the guarantee provided that the guarantor would pay on demand to RBC:

> …all debts and liabilities, present or future, direct or indirect, absolute or contingent, mature or not, at any time owing by [SMS to RBC] or remaining unpaid by [SMS] to the

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24 Conlin, supra note 23 at para 4.

25 Ibid at paras. 4, 8, 15 and 22.

26 See Royal Bank of Canada v Samson Management & Solutions, 2013 ONCA 313 [*Samson*] and Posocco v Battista et al, 2015 ONSC 6398 [*Posocco*] in which the courts enforced the guarantees despite material alterations made to loan agreements without the consent of the guarantor, including a postponement by the secured creditor which then affected the ability to be repaid from the security.

27 Samson, supra note 26 at para 64.
Bank, heretofore or hereafter incurred or arising and ... incurred by or arising from agreement or dealing between the Bank and [SMS].

Similarly, the Ontario Superior Court of Justice recently ruled in Posocco that the guarantor waived their common law right to the defence of material alteration. The Court held that the language of the guarantee was “extremely broad” and “…the terminology contained in paragraph 2(iii) permitting the creditor to ‘vary any security in whole or in part’ must be read to include the subordination or postponement of the mortgages.”

While the Samson and Posocco cases demonstrate that it is possible to contract out of the material alteration defence, Canadian courts have not addressed whether other common law defences can be waived as well. This may develop into a future problem as most, if not all, standard form guarantees used by institutional lenders are drafted so that the guarantor waives the common law defences. However, as the requirements for waiver in Conlin demonstrate, clauses binding the guarantor must be clear, strictly construed, and interpreted in favour of the guarantor in the event of any ambiguity. Therefore, it is unlikely that Canadian courts would allow guarantors to waive their rights to the defence of duress, undue influence, or non est factum.

(e) The Principal Debtor Clause

Guarantees are usually drafted so that the guarantor assumes a primary debt obligation. This language is intended to convert the guarantee into an indemnity. An example of a “principal debtor clause” is: The Guarantor shall be liable to the Lender as principal debtor and not as surety only, and will not plead or assert to the contrary any action taken by the Lender in enforcing this Agreement.

In Conlin, the Supreme Court of Canada held that a “principal debtor” clause converted the guarantor into a “full-fledged principal debtor with all the duties and obligations which that term implies”. In other cases, it has been held that similar language was not sufficient to create an indemnity in favour of the lender. Therefore, the mere presence of a “principal debtor” clause is not enough on its own to characterize something as an indemnity. A critical part of the analysis that the courts undertake is considering the language used in the guarantee in its entirety. This involves interpretation of the clauses of the agreement, consideration of the transaction as a whole, and the application of the appropriate rules of construction.

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28 Ibid at para 24
29 Posocco, supra note 26 at para 8.
30 Conlin, supra note 23 at para 21.
31 See Montreal Trust Co of Canada v Birmingham Lodge Ltd (1995), 24 OR (3d) 97 (CA) where the Court held that a guarantor and a principal debtor are mutually exclusive concepts, and that, if a lender's actions or documents characterize a party as a guarantor, the lender is thereafter precluded from seeking recovery against that guarantor as if it were a primary debtor.
32 Conlin, supra note 23 at para 21.
D.  Enforcing a Guarantee

(a) Generally

A guarantee of an institutional lender is usually drafted using specific language and as a result, enforcement is typically straightforward, without much controversy. Absent an agreement to the contrary, it is presumed that the liability of the guarantor arises upon the default of the principal.\(^3\) The creditor is not under an obligation to the guarantor to do anything other than call upon the principal to perform, to accept the performance of the principal if tendered, and, if the guarantee is a true guarantee and not an indemnity, not require the guarantor to pay when the principal is not liable to pay.\(^3\) A guarantee will generally be construed strictly contra proferentum so as to resolve any ambiguity in favour of the guarantor.\(^3\)

(b) Independent Legal Advice

Another issue in the enforcement of guarantees that lenders should be aware of is independent legal advice. While there is no requirement that a guarantor obtain independent legal advice in order for the guarantee to be enforceable,\(^3\) many lenders now require guarantors to obtain independent legal advice at the time of providing a guarantee. This is common practice where a family home is mortgaged as security for a guarantee of a business loan or where a spouse is guaranteeing their spouse’s business loan.

The provision of independent legal advice increases the likelihood that a guarantee will be found to be enforceable. The Ontario Superior Court of Justice held in *Royal Bank of Canada v 2240094 Ontario Inc*\(^3\) that, “…independent legal advice is not a prerequisite for a bank to make a claim against a guarantor; however, the presence of independent legal advice is useful to a bank, because it provides a means to negate any pleas of non est factum or misrepresentation (also pleas of undue influence, duress, fraud, unconscionability).”\(^3\) In order to act as a pre-emptive evidentiary tool, independent legal advice must truly be independent. In *Carvest Capital Inc v Starserra Homes (Riverside) Ltd*,\(^3\) the independent legal advice in a spousal guarantee was questioned because the lawyer was counsel for the borrower and aware of marital difficulties.\(^3\)

(c) Notice of Sale to a Guarantor

In cases where a mortgage goes into default, the question arises as to whether the guarantor is entitled to be served a copy of the Notice of Sale. Under section 31 of the *Mortgages Act*, persons listed on the ‘parcel register’ have an interest in the land.\(^3\) Where a guarantor has paid a portion of the mortgage debt, it will be subrogated to the lenders’ position, and will have an


\(^{34}\) McGuinness, *supra* note 14 at 349.

\(^{35}\) *Bank of Montreal v Korico Enterprises Ltd* (2000), 50 OR (3d) 520 (CA) at para 16.

\(^{36}\) *Bank of Montreal v Featherstone* (1989), 68 OR (2d) 541 (CA) at para 20.


\(^{38}\) Ibid at para 16.

\(^{39}\) *Carvest Capital Inc v Starserra Homes (Riverside) Ltd*, 2009 CarswellOnt 2908 (Ont SCJ).

\(^{40}\) Ibid at para 25.

\(^{41}\) *Mortgages Act*, RSO 1990, c M40, s 31.
interest in the property. Although it may be difficult to determine whether or not a guarantor has been making payments on the charge, a prudent lender should include guarantors on the service list for a Notice of Sale to avoid imperiling the power of sale proceedings.

(d) Foreclosure Proceedings

A guarantor for a mortgage debt is not entitled to standing in foreclosure proceedings. For example, a guarantor for a mortgage whose liability arises merely by covenant and who has paid nothing on the mortgage is not a necessary party to an action for foreclosure because they do not have an interest in the property. In contrast, a guarantor who has joined a co-mortgagor with the principal debtor or who has paid part of the mortgage debt is a proper and necessary party.

(e) Limitation Periods of Guarantees contained in a Mortgage

There are different limitation periods depending on whether a guarantee is a standalone guarantee, or a guarantee contained within a mortgage. In a standalone guarantee, the Limitations Act, 2002, provides a limitation period of two years from demand:

4. Unless this Act provides otherwise, a proceeding shall not be commenced in respect of a claim after the second anniversary of the day on which the claim was discovered.

5(3) …the day on which injury, loss or damage occurs in relation to a demand obligation is the first day on which there is a failure to perform the obligation, once a demand for the performance is made.

In a commercial real estate standalone guarantee, there is a real risk that the disposition and realization could exceed the two-year limitation period. If the guarantee is part of the mortgage document itself, however, the limitation period is ten years as per section 43 of the Real Property Limitations Act. As a result, a creditor will have ten years to pursue the guarantor for a deficiency in an intra-mortgage guarantee.

(f) Need for Demand on Guarantee

The limitation period on a demand guarantee begins to run from the date that demand was made. When crafting a guarantee, parties must determine whether or not it is desirable to require that demand be given before the debt is due. This intersection of the Limitations Act, 2002 provisions on demand obligations and the non-demand nature of certain guarantees leads to

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42 Canadian Financial Co v First Federal Construction Ltd (1982), 34 OR (2d) 681 (CA) at para 19.
45 L-Jalco Holdings Inc v Marino, 2011 ONSC 710 at para 56 [L-Jalco].
46 Limitations Act, 2002, SO 2002, c 24, Sch B.
47 Ibid at s 4 and s 5(3).
48 Real Property Limitations Act, RSO 1990, c L 15, s 43.
49 As noted above, the Limitations Act, 2002 creates a limitation period of two years. However, section 5(3) of the Limitations Act, 2002 only applies with respect to demand obligations created on or after January 1, 2004. For demand obligations predating that period, the common law position reigns, and the limitation period began to run from the moment the loan was advanced.
unusual situations. In *Skuy v Greenough Harbour Corporation*, the Ontario Superior Court of Justice explained how a guarantee that does not require demand may nonetheless be a demand guarantee:

Where the parties to a guarantee incorporate a demand as a condition-precedent to the guarantor's liability, liability does not crystallize until a proper demand has been made and the limitation period commences upon the receipt of the demand...

Moreover, to add to the complexity (and to provide another example of the confusing nature of the law) some demand obligations can be enforced without an actual demand having been made. A creditor claiming under a guarantee is not required to make a demand before action unless the plain wording of the guarantee requires this to be done.  

In *Skuy*, the Court held that the original debt created by a promissory note was statute barred. However, the Court found that the guarantors were liable on their guarantees of that debt because there had not been demand on the guarantees, and that therefore the limitation period had never started in respect to the guarantees.  

To complicate the situation further, the Ontario Court of Appeal has conclusively accepted service of a Notice of Sale as ‘demand’ on a demand guarantee.

(g) Pursuing the Borrower First

Unless the guarantee provides otherwise, the creditor does not have to bring an action against the borrower before demanding payment from the guarantor. In a guarantee, the right of action against the guarantor arises upon the default of the principal itself.

(h) Bankruptcy of the Borrower

As a general rule, if the borrower is in an insolvency proceeding, which includes bankruptcy, receivership or restructuring proceedings under the *Companies’ Creditors Arrangement Act* or the *Bankruptcy and Insolvency Act*, the enforcement of a claim against a guarantor is typically not stayed. Neither the bankruptcy of the borrower nor an order of discharge in the bankruptcy of the borrower discharges the guarantor from liability.

Generally there is no ability for a borrower in a restructuring proceeding under the *CCAA* or the *BIA* to disclaim or repudiate a financing agreement (although there is statutory authority for a borrower to disclaim several types of executory contracts).

Often if a borrower is the subject of an insolvency proceeding, a lender will look to its security against the borrower before making a demand against a guarantor. In this way, the limitation period against the guarantor does not start until the demand against the guarantor is made. If the

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50 *Skuy v Greenough Harbour Corporation*, 2012 ONSC 6998 [*Skuy*].
51 *Skuy*, supra note 50 at paras 36-37.
52 *Ibid* at paras 53-54.
54 *Companies’ Creditors Arrangement Act*, RSC, 1985, c C-36 [*CCAA*].
55 *Bankruptcy and Insolvency Act*, RSC 1985, c B-3 [*BIA*].
56 *Ibid* at s 179.
demand were made at the time of the default by the borrower, the lender may be statute barred against the guarantor if it waits too long to commence proceedings against the guarantor.

Of course, if a guarantor has given security, a lender may decide to enforce the guarantee and related security concurrently with the enforcement against the borrower.
(i) Bankruptcy of the Guarantor

If the guarantor has not provided any security to the lender and the guarantor is then the subject of an insolvency proceeding, the lender’s ability to enforce against the guarantor will be stayed and the lender will need to file a proof of claim. If the lender has been provided with security by the guarantor then the lender will be in a better position to enforce its claims against the guarantor depending on the nature of the insolvency proceeding.

(j) Bankruptcy Remoteness

One key element in the United States (and in Canada in respect of MBS deals) is requiring the borrower to continue to be a non-recourse loan a special or sole purpose entity. In the United States, creditors’ concern over a court ordering substantive consolidation of assets of affiliated borrowers (and allowing all creditors access to this aggregate pool of assets) and the (potentially detrimental) impact on a secured creditor, has led to differing theories and lists of covenants of borrowers to ensure separation of the borrower from its affiliated companies.

Canada is similar to the United States in that substantive consolidation is a result of the court exercising its discretion in equity (rather than as a result of a statutory provision). However, in the United States there are many more cases setting out different tests for substantive consolidation, than there are in Canada. In both United States and in Canada, decisions are heavily influenced by the particular facts. However, substantive consolidation is much less common in Canada than in the United States, particularly where it would prejudice any particular creditor. Where it has been ordered, the principal secured creditor has supported it. This uncertainty combined with the risk to creditors in the United States has resulted in attorneys in the United States being requested to give opinions on bankruptcy remoteness. In talking with two of my colleagues in bankruptcy law, with 15 and 25 years’ experience respectively, only one had been involved in such an opinion and was not aware of other such opinions. In short, an opinion on bankruptcy remoteness and substantive consolidation is unusual in Canada.

E. Recourse vs. Non-Recourse Loans

(a) Generally

In a recourse loan, the debt may be satisfied by pursuing the borrower’s other assets in addition to the collateral securing the loan. By contrast, in a non-recourse loan, the lender’s enforcement is limited to the collateral securing the loan. In the case of a mortgage, the enforcement is against the mortgaged property. Many commercial loans, including many commercial mortgage loans, remain full recourse loans. The main exceptions, where mortgage loans are non-recourse, are mortgage loans that will be securitized, where the borrower is a REIT, where the borrower has a strong covenant, or where the value of the mortgaged property is much higher than the loan amount (i.e. the loan to value ratio is low).

(b) Anti-Deficiency Rules

Several States in the United States have anti-deficiency statutes that prohibit the ability of the lender to recover any deficiency following the foreclosure of an obligation secured by a
mortgage or deed of trust. However, in Ontario, there are two main enforcement mechanisms specific to mortgages: foreclosure or power of sale. Power of sale is used more frequently as it is a simpler and faster procedure. In addition, with a sale under a power of sale, lenders have the ability to sue the borrower and the guarantor for any deficiency after a sale pursuant to a power of sale, unless the borrower or guarantor is prejudiced because the lender did not comply with the applicable law in enforcing its power of sale.

In foreclosure, a lender cannot recovery the deficiency from the borrower if the lender is not in a position to re-convey the mortgaged property to the borrower or if a final order of foreclosure has been obtained. In addition, in foreclosure, a lender can recover a deficiency from an indemnitor (again, provided the indemnitor is not prejudiced by the lender’s non-compliance with applicable law), but not a guarantor (if the borrower would not be liable for the deficiency).

F. Carve-outs to Non-Recourse Loans (“Bad Boy Carve-outs”)

An area of concern in non-recourse loans is whether the lender should be protected from losses, or be able to make the loan fully recourse, if the borrower has committed (by act or omission) improper acts such as fraud, misuse of funds, allowed environmental contamination, or damaged the value of the mortgaged property. This issue is often resolved by a separate agreement signed by the borrower, any guarantors, and the shareholder of the borrower, which expressly allows recourse to the other assets of the parties, if any of these acts occur. This type of indemnity is commonly referred to as a “bad boy indemnity” and the triggering events referred to as “non-recourse carve-outs”. Bad boy indemnities are often signed by the principals/shareholders of the borrower, in addition to the borrower, to expand the pool of assets available to the lender.

When acting for a borrower, it is important to ensure that the lender is not using carve-outs to convert the non-recourse loan facility into the practical equivalent of a full recourse loan. This issue arose in the United States, most famously in Wells Fargo Bank, NA v Cherryland Mall Limited Partnership. Cherryland, however, was subsequently overruled by legislation in the State of Michigan and the legislation was upheld by the United States Court of Appeals for the Sixth Circuit in Borman, LLC v 18718 Borman, LLC. A similar carve-out issue also arose in Blue Hills Office Park LLC vs JP Morgan Chase Bank where the Court permitted the lenders to recover the “full amount” of the deficiency after a foreclosure, without regard to whether the

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57 L-Jalco Holdings Inc v Marino, 2011 ONSC 710 at para 71.
59 Wells Fargo Bank, NA v Cherryland Mall Limited Partnership et al, 2011 WL 6785393 (Mich App Dec 27 2011) [Cherryland] wherein the Michigan Court of Appeal determined that based on the language of the mortgage, failure by the borrower to remain solvent resulted in a breach of its covenant to maintain “special purpose entity” status, thereby allowing full recourse to the loan worth $8.7 million. As a result, the lender was able to recover the $2.1 million deficiency from the guarantor when the property was sold in foreclosure.
60 See section 3(1) of the Nonrecourse Mortgage Loan Act which provides that a post-closing solvency covenant shall not be used, directly or indirectly, as a nonrecourse carve-out or as the basis for a claim or action against a borrower or any guarantor or other surety on a nonrecourse loan.
61 Borman, LLC v 18718 Borman, LLC, 777 F 3d 816 (6th Cir).
62 Blue Hills Office Park LLC vs JP Morgan Chase Bank, 477 F Supp 2d 366 [Blue Hills].
covenant breach caused the full loss. Despite these examples in the United States, comparable cases have not developed in Canada where carve-outs to non-recourse loans resulted in the loans being converted from non-recourse into fully recourse.

G. “Above the Line” vs. “Below the Line”

In the United States, carve-outs are generally broken into two categories: (1) above the line and (2) below the line. Above the line carve-outs typically refer to recourse events by which loss, cost, damage or expense suffered by the lender become recourse to the borrower (and, in turn, the guarantor). These events do not trigger full recourse liability for the entirety of the loan. Rather, the guarantor is only liable for the loss, cost, damage or expense suffered by the lender due to the applicable carve-out. Examples of above the line carve-outs include fraud or intentional misrepresentation, gross negligence, breach of environmental covenant, waste, and failure to pay taxes or other property charges than can create liens on the property.

Below the line carve-outs typically refer to “full recourse” carve-outs which make the debt fully recourse upon the occurrence of the applicable carve-out. Examples of below the line carve-outs include, breach of cash management provisions, breach of “no sale” provisions, and bankruptcy of the borrower.

The extent of non-recourse carve-outs is more straightforward in Ontario as they are often limited to an indemnity for fraud, misuse of funds, and environmental contamination. Furthermore, issues that arise in the United States respecting bankruptcy of the borrower where the assets of all related companies are used to pay all creditors pro rata, does not exist in Canada except in unusual circumstances where substantial consolidation may be ordered. As a result of narrower bad boy indemnities, the very strong bargaining power of lenders in Canada, and the difference in bankruptcy laws, non-recourse carve-outs are not as heavily negotiated in Ontario as they are in the United States. In addition, most non-recourse carve-outs in Canada are “above the line” (i.e. limited to the actual loss and do not make the entire loan full recourse).

H. Drafting, Negotiating and Enforcing Carve-outs to Non-Recourse Loans

It has been suggested by some United States commentators that there is strict construction of carve-outs in the United States, often resulting in rulings favourable to the lender. As highlighted in Cherryland and Blue Hills, the literal interpretation of the mortgage loans and guarantees was the determining factor which allowed the lenders in each case to enforce the carve-out and fully recover any deficiency. Furthermore, these outcomes occurred despite potential violations of public policy, actions beyond the guarantor’s control, and the significant adverse impact of converting a non-recourse to a fully or partially recourse loan.

In contrast, if Cherryland and Blue Hills had been heard in Canadian courts, the rulings may have been more favourable to the borrower. This is because Canadian courts are tasked with a plain reading of the contract, identifying the intent of the parties, and giving effect to it. In addition, Ontario Courts have held that a guarantee will generally be construed strictly in favour
of the borrower or guarantor if there is any ambiguity.\textsuperscript{63} It follows that in drafting a guarantee with carve-outs, it is imperative that the words accurately reflect the intentions of the parties.

There has been little judicial consideration of enforcing carve-outs to non-recourse loans in Canada. In \textit{Canada v McLarty},\textsuperscript{64} the Supreme Court of Canada only mentions non-recourse loans in passing as limiting the creditor to recovery of specified security.\textsuperscript{65} In absence of Canadian case law dealing with the interpretation and enforcement of carve-outs to non-recourse loans, both guarantors and creditors should draft carve-outs that identify their intent and are plainly worded.

\section{Conclusion:}

In Canada, guarantees and indemnities in commercial mortgage loan transactions provide assurance to a lender that a debt will be repaid. As this paper has demonstrated, however, the function of these agreements is very different. In a guarantee, the promisor will pay only if a third party does not, whereas with an indemnity, the promisor is liable to pay in any event. To complicate this distinction further, it is common in Canada for agreements labelled “guarantee” to act in practice like an indemnity.

To understand the complexities of drafting and interpretation, it is important to recognize that guarantees and indemnities are interpreted in accordance with the principles of contract law. As a result, guarantors and indemnitors are protected by defences ordinarily available to breach of contract. Despite these protections, it has become common in Canada that a guarantor or indemnitor will contract out of the protection provided by the common law or equity if the language in the guarantee/indemnity is clear and unambiguous.\textsuperscript{66} This has resulted in guarantors being held responsible for payment on a mortgage loan despite material alterations made to the loan without the consent of the guarantor. In short, as long as the common law and equitable protections are waived and there are no other vitiating factors, the enforceability of guarantees and indemnities is relatively straightforward.

Moreover, the distinction between recourse and non-recourse loan agreements is important in the Canadian context. When drafting and negotiating guarantees or indemnities in a non-recourse loan, lenders may include carve-outs in an attempt to protect the lender from losses or to convert the loan into a fully recourse loan if the carve-out event occurs. In contrast to the \textit{Cherryland} and \textit{Blue Hills} decisions in the United States, there have been no cases in Canada where carve-outs in non-recourse loans have resulted in these loans becoming fully recourse. As a precaution, however, it is important that guarantees and indemnities of both recourse and non-recourse loans be drafted in a way that ensures clarity and intent of the parties.

Despite the parallels between guarantees, indemnities, non-recourse mortgages, and carve-outs in Canada and the United States, there are unique differences. This paper is not exhaustive of those differences, but provides an overview of this area of law in order to offer clarity to both a Canadian and American audience. By providing a Canadian perspective, it is our hope that the

\textsuperscript{63} \textit{Bank of Montreal v Korico Enterprises Ltd} (2000), 50 OR (3d) 520 (CA) at para 16.
\textsuperscript{65} \textit{McLarty}, supra note 67 at para 29.
\textsuperscript{66} \textit{Conlin}, supra note 23 at para 4.
reader will be better equipped to navigate the intricacies of Canadian commercial mortgage transactions going forward.
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