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# Commercial Real Estate Loans: Negotiating Carve-out Guaranties

## Online Contents



This Practice Note from our website discusses non-recourse carve-out guaranties, often referred to as bad boy guaranties. These guaranties are common in non-recourse loans secured primarily by commercial real estate. This Note provides guidance on negotiating carve-out guaranties, with drafting techniques to help limit excessive risks that may be faced by carve-out guarantors.

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The recent downturn in the commercial real estate market has highlighted just how far non-recourse carve-outs have deviated from the premises that drove them. Recent court decisions have come as unpleasant surprises for real estate investors who signed non-recourse carve-out guaranties. In some cases, these guaranties have been interpreted as a full guaranty of the entire loan, a result entirely inconsistent with industry standards and expectations.

This Note explains how carve-out guaranties evolved and, more recently, mutated. It also suggests how guarantors and their counsel should negotiate these documents given current trends.

## WHAT ARE CARVE-OUT GUARANTIES?

Commercial real estate borrowers and lenders typically structure their financing arrangements as non-recourse loans. This means, in essence, that if the borrower defaults, the lender can exercise remedies against the collateral, but it cannot make a claim against anyone going beyond the collateral.

Traditionally, commercial real estate lenders did not rely on anyone's credit when assessing the ordinary risks of a particular loan. Lenders gave some practical weight to the depth of the pockets of the borrower's principals, but typically did not demand that the principals back the loan with their personal credit. Even the deepest pockets retained the right to walk away if a property went bad.

Non-recourse carve-out guaranties, also colloquially known as "bad boy guaranties" (carve-out guaranties), have become a fundamental part of any typical non-recourse loan structure. They allow the lender to have recourse beyond the collateral for certain negotiated matters that are expressly "carved out" from non-recourse treatment. These non-recourse carve-outs generally relate to:

- Certain "bad acts" the lender does not want the borrower to commit.
- Major external risks affecting the collateral, such as environmental problems.

### LENDER'S RECOVERY AGAINST CARVE-OUT GUARANTOR

If the borrower commits one of the specified bad acts, or if one of the carved-out events occurs, then the lender can recover against the guarantor, either for:

- **Loss liability.** Here, the lender quantifies the losses that the lender incurred as a result of the carved-out risk, and then recovers from the guarantor the amount of those losses.
- **Full loan liability.** In a few cases, the lender may recover the entire amount of the loan from the guarantor. Full loan liability carve-outs have traditionally been reserved for particularly egregious acts by the borrower and particularly serious external risks to the collateral.

If the lender obtains a judgment against the guarantor, whether for loss liability or full loan liability, the lender can enforce it against any of the assets of the guarantor, not just the collateral. The guarantors under these guaranties will often consist of the ultimate owner(s) of the borrower, whether an individual, multiple individuals, an entity or some combination.

### EVOLUTION OF CARVE-OUT GUARANTIES

In the 1980s, non-recourse carve-outs were very few and very straightforward. They carved out from non-recourse treatment only a handful of matters, such as:

- Fraud.
- Misapplication of insurance proceeds or condemnation awards.
- "Waste" of the mortgaged property.
- Environmental matters.

Over time, non-recourse carve-outs became far more complicated and extensive than the short list summarized above. The intricacies of modern non-recourse carve-outs have sometimes produced results that the parties to the original transactions never anticipated. This evolution has changed the character of non-recourse lending and turned a footnote into the most important chapter of the book.

Today, in some cases, all kinds of problems that may affect a troubled property can trigger a non-recourse carve-out under a carve-out guaranty. This includes borrower defaults where traditionally the lender's recourse would not extend beyond the collateral. The risk of those defaults was just part of the risk borne by lenders in non-recourse loans secured by real estate. If a default occurred, the lender would foreclose, take the collateral, and that would be the end of that problem. The ability to take the collateral gave the lender enough comfort.

The fallout from the recent downturn in the commercial real estate market underscores just how much non-recourse carve-outs have expanded. Over time, as the list of non-recourse carve-outs grew, it occasionally seemed, at least in recent litigation, that a lender could offer a rationale to convert a wide range of obligations under the loan documents into non-recourse carve-outs. Some obligations became full loan liability carve-outs.

In addition, thanks to recent court decisions, what started out as a carve-out guaranty has been interpreted as a full guaranty of the entire loan, a result entirely inconsistent with industry standards and expectations. These decisions were often based on a very limited and narrow reading of a convoluted collection of interacting defined terms in the loan documents.

>> For more information on the evolution of carve-out guaranties and recent court decisions, search Trends in Carve-out Guaranties on our website.

## HOW GUARANTORS CAN PROTECT THEMSELVES

Today's lenders seem to continue their efforts to convert non-recourse carve-outs into the all-purpose remedy for every possible problem that might occur with a real estate loan. The recent pro-lender decisions may have encouraged this trend. For example, recent loan documents have included non-recourse carve-outs for:

- "Economic waste," which is a dangerously ambiguous concept.
- Failure to replace the property manager when required under the loan documents.
- Prohibited modification of a franchise agreement (in the case of a hotel).
- The borrower's negligence or gross negligence.
- Bankruptcy filings initiated by passive investors in the borrower.
- Any claims arising under the Racketeer Influenced and Corrupt Organizations (RICO) Act.

Lenders have also tried to broaden further the definition of "borrower" for purposes of determining which bad acts are the acts of the borrower. Often the definition of borrower extends far beyond anyone that a carve-out guarantor can actually control.

In negotiations, guarantors and their counsel should watch for creeping non-recourse carve-outs, and the all-inclusive approach that some lenders bring to non-recourse carve-outs. Borrowers and guarantors should try to bring lenders back to a more constrained and sedate view of the role of non-recourse carve-outs. In particular, guarantors and their counsel should:

- Specify in detail in the commitment letters the non-recourse carve-outs.
- Carefully assess the scope of the non-recourse carve-outs.
- Limit any exposure to recourse liability for violations of single purpose entity (SPE) and separateness covenants.
- Insist on notice and cure rights, at least for non-recourse carve-outs that might trigger full loan liability.
- Consider using a "zero-based" approach to non-recourse carve-out language.
- Negotiate for a clear exit right, an ability to make it all go away.

### SPECIFY NON-RECOURSE CARVE-OUTS IN COMMITMENT LETTERS

Even more than in the past, guarantors should insist on resolving the non-recourse carve-outs as a gating item when they negotiate a loan. Instead of signing a commitment letter or other deal summary that refers to a lender's boilerplate standard carve-outs, a guarantor should insist that the lender set out those non-recourse carve-outs, word for word. By doing so, the guarantor and its counsel can sign off on the express language as part of the fundamental business sign-off on the financing early on, and ideally before the borrower writes any preliminary check to the lender.

### ASK THE RIGHT QUESTIONS ABOUT NON-RECOURSE CARVE-OUTS

Guarantors should focus on which non-recourse carve-outs are loss liability carve-outs and which are full loan liability carve-outs. Typically, most non-recourse carve-outs are loss liability carve-outs. To the extent that the loan documents go further, guarantors must confirm that any full loan liability carve-out will not, by its words, somehow unintentionally turn the guarantor into a full guarantor of the loan.

In reviewing non-recourse carve-out language, guarantors and their counsel should ask these questions:

- What are the exact words used in the non-recourse carve-out to describe the circumstance that triggers recourse liability, particularly full loan liability?
- Do the words of the non-recourse carve-out refer to defined terms? If so, what are all the concepts and requirements wrapped into each of those defined terms? Does any possible circumstance exist that could trigger recourse liability for a guarantor because the intricacies and interactions of the various defined terms capture a circumstance that was beyond the borrower's control, or a circumstance that is typically considered a lender's risk in any non-recourse loan?
- When the triggering circumstance involves a bad act, can the guarantor control the particular act, regardless of whether occurrence of the act triggers loss liability or full loan liability?
- Does the non-recourse carve-out trigger liability as a result of the occurrence of an ordinary fact of life for any borrower in distress?

Moreover, even if the guarantor can control a circumstance that triggers potential recourse liability, the guarantor should decide if it really wants to control that circumstance. For example, if financial distress at a property triggers recourse liability, does the guarantor want to face the prospect of making payments to prevent the particular bad event (the financial distress) from happening, perhaps repeatedly?

To continue that example, any distressed borrower will probably have more payables than the parties involved would want, or may face ordinary mechanics' liens on its property. Events signaling real estate in distress do not always result from the bad acts of borrowers. For example, mere unpaid operating expenses are a risk that always arises when real estate gets into trouble and should not automatically trigger recourse liability for a guarantor. Any risks arising from unpaid expenses should belong to the lender, and the lender should not care because it should be able to foreclose on the property. That dynamic was part of what motivated non-recourse financing, and it still applies.

As another example, consider mechanics' liens, which sometimes appear in non-recourse carve-outs. These liens should not trigger full loan liability for the guarantor. A guarantor should more typically expect to incur only loss liability, at most, as the result of mechanics' liens. Even then, such liability might not make sense unless the guarantor did something wrongful to create the problem, such as taking distributions from the borrower and leaving the borrower unable to pay its payables and mechanics' lien claimants. The mere occurrence of a financial problem such as a mechanic's lien should not necessarily trigger any form of recourse liability. It is a default and the lender can and should foreclose.

### LIMIT SPE AND SEPARATENESS COVENANTS

SPE and separateness covenants often establish a complex package of borrower obligations, ranging from the fundamental to the trivial. A borrower's non-compliance with any of these covenants could trigger a full loan liability carve-out under a strained and hyper-technical reading of the loan documents (see below *Full Loan Liability Carve-outs*), such as in the recent decision in *Wells Fargo Bank, NA v. Cherryland Mall Ltd. Partnership, 812 N.W.2d 799 (Mich. Ct. App. 2011)*.

>> For more information on *Cherryland*, search Trends in Carve-out Guaranties on our website.

Guarantors and their counsel should:

- Carefully review every SPE and separateness covenant. Ask whether it makes sense for any non-compliance to trigger liability. If so, determine whether either loss liability or full loan liability is appropriate. Usually, the answer will be, at most, loss liability.
- Try to limit loss liability carve-outs to only bad acts within the guarantor's control and limit full loan liability carve-outs to only really egregious acts within the guarantor's control.

SPE and separateness covenants are complex and may go into great detail. Even though SPE and separateness covenants are important, not every breach should trigger a full loan liability carve-out. For example, these covenants often require the use of separate letterhead and telephone numbers. The borrower's failure to do so should not trigger a full loan liability carve-out.

Guarantor's counsel may also ask that recourse liability for SPE or separateness violations should not arise at all unless the borrower's non-compliance with those covenants was somehow wrongful or an intentional and substantial breach. Moreover, perhaps a guarantor should face liability only if the borrower's violations actually result in the borrower's becoming consolidated with some other entity. Such risk, after all, is the concern that originally led to SPE and separateness covenants. The lender did not really care about, for example, separate letterhead in and of itself and the failure to do so hardly seems a suitable predicate for substantial recourse liability.

### Borrower's Insolvency and Guarantor Liability

In the *Cherryland* decision, a court construed complex and intricate SPE and separateness covenants to mean that the mere insolvency of the borrower, even without a bankruptcy filing (whether voluntary, collusive, involuntary or otherwise) triggered full loan liability for the guarantor. This was an unexpected interpretation of the non-recourse carve-outs, because no guarantor of an ordinary non-recourse loan would expect to have assumed general responsibility to preserve the borrower's solvency.

Such an obligation would, in effect, force the guarantor to contribute unlimited capital to the borrower. It would, in effect, create an open-ended claim on the guarantor's other assets, precisely the type of exposure that non-recourse clauses were supposed to prevent. A guarantor's obligation to preserve the borrower's solvency would preclude the guarantor from ever "walking away" from an investment that turned out badly, which is the option that a non-recourse loan was supposed to give the principal of any commercial real estate borrower. The principal is not supposed to have an obligation to contribute unlimited capital to the borrower.

Originally, full loan liability carve-outs triggered by voluntary insolvency started from the reasonable proposition that a guarantor controls the borrower and can prevent the borrower from filing a voluntary bankruptcy, often regarded as a borrower's most lethal weapon against its lender. Later, that proposition was expanded, also appropriately, to include the proposition that the borrower should not in any way collude with the filing of an involuntary bankruptcy, because that functionally amounts to the filing of a voluntary bankruptcy. It makes sense for the guarantor to face full loan liability if the guarantor uses its control of the borrower to cause or even just facilitate such a filing.

Although carve-out guarantors will probably need to continue to live with exposure to these risks, they can take some steps to mitigate them and manage their scope. Guarantors and their counsel should scrutinize the non-recourse carve-outs relating to the borrower's insolvency, without just accepting the idea that anything related to voluntary or collusive insolvency should always trigger a non-recourse carve-out.

Guarantors should consider, for example, the following:

- **Insolvency.** Look at how the loan documents define an "insolvency" triggering event for full loan liability. Those definitions often go beyond bankruptcy and include a number of other adverse financial events. For example, loan documents sometimes define voluntary insolvency to include the borrower's written admission that it is unable to pay its debts. No guarantor would want this to mean the guarantor faces full loan liability if the borrower writes a letter to the lender saying the borrower is experiencing financial distress.
- **Collusion.** What does it mean to collude with an involuntary bankruptcy filing? If a creditor of the borrower requests a current financial statement with backup showing all the borrower's other creditors, and the borrower complies, does that constitute collusion? The guarantor should consider limiting the meaning of collusion, although this may create even more complexity and uncertainty. In addition, trying to define collusion may lead lenders to take a hard line in those discussions, saying that anything the borrower does to directly or indirectly facilitate an involuntary filing should constitute collusion. The guarantor might have done better with vagueness and lack of a definition. That is a judgment call for the guarantor and its counsel.
- **Guarantor's conflicts.** If the guarantor is or controls the manager of a limited liability company (LLC), the guarantor must think about possible liability to passive investor members if the manager "should have" had the LLC file bankruptcy to protect the LLC's business, but chose not to because the guarantor wanted to avoid triggering full loan liability for a voluntary filing. These concerns should drive protective waivers and acknowledgments in the LLC documents. The same concerns arise in partnerships.
- **Borrower's net worth.** The guarantor should try to steer clear of any recourse-triggering event that merely considers the borrower's assets and liabilities and whether the borrower has a positive net worth. Instead, the guarantor should limit any insolvency-based trigger for recourse liability so it arises only if the borrower causes an actual event that exposes the lender to the risks of the bankruptcy or insolvency process.

The details of any insolvency-related non-recourse carve-out can make a huge difference. Guarantors and their counsel must review them very carefully. A few words here and there were all it took for the courts to render some very surprising recent decisions.

## REQUEST NOTICE AND CURE RIGHTS FOR SOME NON-RECOURSE CARVE-OUTS

A guarantor may request the right to receive notice of a borrower default and an opportunity to cure it (notice and cure rights) before the guarantor faces personal liability. While this can give the guarantor a chance to respond and take action to prevent draconian surprises, notice and cure rights cannot fully solve any guarantor's concerns about excessive non-recourse carve-outs. For example, if a guarantor faces liability for unpaid operating costs as a result of the SPE covenants, the guarantor should focus on limiting the non-recourse carve-out so it does not bear an ordinary risk of real estate failure, the type of risk that does not justify a creditworthy backstop.

### Loss Liability Carve-outs

In the case of loss liability carve-outs, notice and cure rights do not change the result much. If the guarantor receives notice of a default that could trigger loss liability, then the borrower might cure whatever default the notice mentioned, probably with a capital infusion from the guarantor that is at most equal to the guarantor's exposure if the guarantor incurred loss liability for that particular carve-out. If the borrower does not cure the default, then the guarantor will need to step in and cure it. This could happen potentially again and again. In this context, notice and cure rights may merely delay or change the format for the guarantor's expenditure, but they do not really protect the guarantor from exposure.

The real issue is whether the guarantor should have assumed loss liability exposure for that problem at all. If, for example, the guarantor assumes loss liability for unpaid operating expenses, but has notice and cure rights, then the net effect merely makes the guarantor personally liable for all operating expenses of the borrower. This is not what anyone would expect in a typical non-recourse financing.

Although notice and cure rights do not help a guarantor much for loss liability carve-outs, a guarantor may still demand them, for example, because a particular guarantor has a fundamental aversion to any risk of any personal liability, even if the cost of avoiding that liability consists of contributing capital to the borrower in the exact amount of the liability prevented.

### Full Loan Liability Carve-outs

In contrast to the limited value of notice and cure rights for loss liability carve-outs, these protections can make a huge difference for guarantors in the context of full loan liability carve-outs. Here, notice and cure rights will function much as they do in protecting a borrower from a disaster, such as acceleration of the loan.

Full loan liability carve-outs have historically triggered personal liability with no requirement to give the guarantor notice and cure rights. That approach made sense when full loan liability carve-outs arose only from simple and egregious acts, such as filing a voluntary bankruptcy. The lack of notice and cure rights for a guarantor make much less sense if full loan liability carve-outs also cover complex minor matters (such as mechanics' liens or small tax liens that the borrower promptly pays) and infractions of SPE covenants that do no real harm to the lender.

Just as any borrower should always demand notice and cure rights before the lender can accelerate the loan or impose default interest, a guarantor of a non-recourse financing should demand notice and cure rights for any event that could trigger full loan liability. In contrast to loss liability, the imposition of full loan liability upon a guarantor could create a financial catastrophe.

Guarantors should demand notice and cure rights for any event, except probably for certain very specific types of bankruptcy filings, that could under any circumstance or characterization trigger a full loan liability carve-out. In some cases, a guarantor may even want the lender to agree to notify the guarantor as soon as the lender becomes aware of a problem that could trigger liability, even if the lender does not presently intend to assert such liability. That way the guarantor could address the problem soon after it occurred, instead of facing some surprise later.

Lenders may respond by agreeing to give notice and cure rights only for innocent or minor breaches (such as a prohibited transfer of a 2% equity interest in the parent company of the borrower's passive investor member), but not for anything more substantial or serious. This is because most full loan liability carve-outs were traditionally so serious that they merited immediate and severe consequences. That response made sense when full loan liability carve-outs related only to severe and egregious actions by the borrower. Now that full loan liability carve-outs have sometimes mutated far beyond that point, a guarantor should insist on a presumption of receiving notice and cure rights.

## CONSIDER USING A "ZERO-BASED" APPROACH

Instead of adding another layer of exclusions, complexity and verbiage to non-recourse carve-out language (such as "nothing in this non-recourse clause shall require anyone to contribute additional capital to the borrower"), guarantors should consider adopting a "zero-based" approach to these provisions. Rather than make the non-recourse carve-outs more complicated, a guarantor and its counsel should try to make them simpler, by placing the burden on the lender to justify each non-recourse carve-out and define it in a simple and direct way.

A guarantor should be able to fully understand and control its recourse liability just by looking at a few very straightforward provisions. Those provisions should fully reflect from the beginning a:

- Clearly defined scope of liability.
- Reasonable set of limitations and protections for the guarantor.

In no case should a guarantor face even a possibility of recourse liability unless something truly bad happens, and the guarantor could have prevented it and, in many cases, had a reasonable opportunity and ability to do so.

>> For a sample non-recourse carve-out guaranty provision, search Non-recourse Carve-out Guaranty Provisions on our website.

Guarantors may also demand that for purposes of non-recourse carve-outs, lenders move away from using interacting cross-references to terms with complex definitions, some of which cross-refer to other terms with their own complex definitions. For example, a laundry list of SPE covenants often contains several dozen specific covenants. By capturing every one of those covenants as a possible non-recourse carve-out trigger, the loan documents create an unreasonable risk of recourse liability that no one anticipated.

Instead, if an event is so bad that it should trigger recourse liability of any kind, the lender should bear the burden of describing that event in simple and straightforward terms in one place, within the four corners of the non-recourse carve-outs themselves. And the guarantor and its counsel should test each such event against these standards:

- Substantiality.
- Controllability by the borrower, the guarantor or both, except in the case of a few external risks, such as environmental problems.
- Its link to actual bad acts of the borrower, rather than to the ordinary stresses of commercial real estate that may suffer distress.
- Absolute clarity, with no room for uncertainty or lender discretion.
- A defined and limited scope.

## NEGOTIATE A CLEAR EXIT RIGHT

As guarantors and their counsel figure out how to respond to recent pro-lender cases, they may also re-examine one of the fundamental premises of non-recourse financing: the idea that non-recourse loans give the borrower the ability to "walk away" from a bad investment and face no further liability. This premise assumes that if a property gets into trouble and the borrower wants to stop pouring resources into it, then the lender would quickly foreclose and cut off the borrower's liability.

Recently, however, foreclosure has been the last remedy a lender typically wants to pursue for a troubled loan. Instead, lenders seem far more likely to look to the carve-out guarantor for any claims the lender can plausibly make because of the property's problems. Perhaps the lender also hopes that, given enough time and delay, the borrower will eventually do something to trigger the carve-out guaranty. Here, the guarantor would actually prefer that the lender foreclose. If the lender forecloses, the guarantor can stop making whatever payments are necessary to fend off recourse liability and can stop worrying about the risk of something happening that might trigger more liability. A guarantor cannot, however, force a lender to foreclose.

A guarantor might intuitively assume it should be able to terminate its liability by having the borrower convey the collateral to the lender through a deed in lieu of foreclosure. But lenders typically have no obligation to accept such conveyances. Instead, lenders can insist that the borrower retain its ownership of the collateral and the guarantor remain liable under its guaranty.

In response, guarantors and their counsel should consider negotiating for the right to cut off any further liability, beyond any liability that has already accrued, under a carve-out guaranty. They can do this by making sure that the loan documents allow the borrower to either:

- Tender a deed in lieu of foreclosure to the lender.
- Give the lender total control of the property with the right to sell it, while the borrower remains the technical owner of the property. This is a practical solution because lenders usually do not want to take title to the property, and each transfer of ownership may incur a tax.

In either case, the guarantor would remain "on the hook" for any liability (or at least certain categories of liability) that had already arisen under the carve-out guaranty, but the guarantor could use the date of the transfer of title or control as the cut-off date for any further accrual of liability. And even a mere offer to deliver a deed in lieu of foreclosure should have that effect, whether or not the lender decides to accept it.

The guarantor could argue that any non-recourse lender should always be willing to accept the collateral, or its functional equivalent, because that is the bargain the lender made when it agreed to make a non-recourse loan secured by real property. If the lender refuses the collateral, then the lender should not have the right to keep making claims under the carve-out guaranty.

The lender may respond to these arguments by negotiating for any, or all, of the following:

- The guarantor must acknowledge or reaffirm on the cut-off date any recourse liability that already exists.
- The carve-out guaranty will not terminate unless the collateral is in good condition and any violations of the loan documents, or at least any violations that trigger recourse liability, have been corrected.
- The guarantor must make a cash deposit sufficient to solve any issues arising from circumstances that may trigger recourse liability for the guarantor. The lender could hold that deposit in escrow until the parties resolve those issues.
- If the deed in lieu of foreclosure incurs a tax, the guarantor must pay it.

Any of these responses from a lender will probably concern the guarantor and its counsel, and lead to protracted negotiations and potentially a new layer of complexity, which then creates additional risks.

## SPECIAL CONCERNS IN MEZZANINE LOANS

In the commercial real estate financing boom that ended in 2008, borrowers and lenders often structured a "debt stack" to include both a traditional mortgage loan and a mezzanine loan, secured by a pledge of the equity of the borrowing entity, or some upper-tier indirect owner of that entity. When one of these structures exists, and either the mortgage or the mezzanine loan goes bad, the interactions between them and their security can create further issues and surprises for carve-out guarantors.

For example, in *Petra CRE CDO 2007-1, Ltd. v. Morgans Group LLC, N.Y. Slip Op. 04175 (App. Div. May 19, 2011)*, the equity owner of the mezzanine borrower signed a carve-out guaranty, triggering full loan liability for the mezzanine loan if the mezzanine borrower made a prohibited transfer. When the mortgage loan went into foreclosure and the mortgage lender ultimately acquired the collateral, the mezzanine lender asserted that this foreclosure in itself constituted a prohibited transfer, making the carve-out guarantor liable for the entire mezzanine loan.

The court disagreed, finding that when the mezzanine loan documents contemplated creation of the mortgage, they also contemplated (and the mezzanine lender assumed) the risk of foreclosure of that mortgage. This decision conforms to the allocation of risks traditionally implied and accepted in non-recourse mezzanine loans.

The converse set of facts can produce a different problem for the carve-out guarantor under a mortgage loan. There, if the mezzanine loan goes into default and the mezzanine lender forecloses, the guarantor may lose the practical ability to prevent the mortgage borrower from committing bad acts, such as filing a voluntary bankruptcy petition. After the mezzanine lender forecloses, the mortgage lender could trigger a full loan liability carve-out against the guarantor based on the bad acts of the mortgage borrower, events the guarantor could no longer have prevented given the guarantor's loss of control of the mortgage borrower.

These examples, and other possible permutations, mean that in any loan transaction involving both mortgage and mezzanine lenders, the carve-out guarantor must protect itself against unexpected recourse liability arising from issues and concerns unique to this structure. More specifically:

- **Loss of control.** If a guarantor loses control of a borrower, then the guarantor should no longer face liability for that borrower's later bad acts.
- **Lender's exercise of remedies.** If a lender exercises its remedies under either the mortgage loan or the mezzanine loan, that should not constitute a prohibited transfer under the other loan, and it should not trigger recourse liability.
- **Liability triggered due to lender's actions.** If a mezzanine lender drove events that might trigger recourse liability, such as a mortgage borrower's bankruptcy, then the guarantor should not incur liability for those events. This may mean that the mezzanine lender, for example, must assume that liability. That is an issue to resolve during the original loan negotiations.
- **Ability to mitigate risks.** The borrower's delivery of a deed in lieu of foreclosure to a mortgage lender may trigger recourse liability for the guarantor. If the guarantor ever thinks the mortgage borrower should deliver a deed in lieu of foreclosure, the mortgage borrower could not do so without the mezzanine lender's consent. To avoid the risk of full loan liability in that case, the guarantor should try to negotiate for the right to have the borrower deliver a deed in lieu of foreclosure to the mortgage lender, and if the mezzanine lender does not want to allow that transfer then the mezzanine lender must persuade the mortgage lender to release the carve-out guarantor from its guaranty. This will probably require:
  - the mezzanine lender or its creditworthy designee to step in as a new carve-out guarantor; and
  - the mezzanine borrower to transfer to the mezzanine lender all the equity interests in the mortgage borrower.

In each of these cases, the guarantor must consider how financial problems at the property level might affect either loan and its non-recourse carve-outs. Any such sequence of events might trigger non-recourse carve-outs that might, in other contexts, sound perfectly reasonable. Both the mortgage loan documents and the mezzanine loan documents need to address these issues. They will also ripple into the intercreditor agreement between the two lenders.

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