

New Traps In Nonrecourse Carveout Guaranties

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Lenders and loan buyers look to nonrecourse carveout guaranties as inspiration for increasingly novel and misguided methods to wring money out of guarantors.

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Today's higher interest rates and downturn in many commercial real estate markets are shining an unfortunate light on the terms of nonrecourse carveout guaranties, the "limited" guaranties that lenders often require principals of borrowers to sign to incentivize the borrower to behave in certain ways. When today's lenders (or opportunistic purchasers of defaulted loans) realize they won't recover their principal and interest through a foreclosure sale, they often pull the nonrecourse carveout guaranty out of their drawer and see what they can come up with to make a claim against the guarantor. Those claims have produced a

number of expert witness assignments for the author. This article summarizes pending claims in which the author is involved, and concludes with some recommendations for borrowers.

In one case, the principals of the borrower signed a personal guaranty making them liable for any loss the lender suffered because of a specified list of actions the borrower might theoretically take. But the guaranty quite appropriately excused the guarantors from liability if the borrower's actions resulted from a lack of revenue from the collateral. The guaranty defined the "Guarantied Obligations" accordingly.

When the loan went bad, the lender sued the guarantors for the full amount of the loan. The court apparently didn't bother to read the definition of Guarantied Obligations, never asking or determining whether anything had actually occurred that might trigger any Guarantied Obligation. Instead, the court just picked up on the word "guaranty" and treated the document as a full guaranty of the loan. So, the court decided that the individual guarantors were responsible for the entire loan, even though that's not what the guaranty said.

In another case, where the lender held a mortgage on a long-term ground lease, the guaranty said the guarantors would incur liability for any "termination" of the ground lease. The borrower—the tenant under the ground lease—missed some rent payments, but the lender covered those payments. The lease remained intact. That didn't stop the lender from claiming that the defaulted rent payments amounted to a termination of the lease, which the lender claimed would justify a huge claim against the personal guarantors.

A third pending example displayed even more creativity by the lender. Here, the nonrecourse carveout guaranty made the guarantor personally liable for the entire loan if the borrower filed bankruptcy or tried to have a "custodian" appointed for the borrower's assets. A "custodian" is typically thought to be a third party appointed by a court to take control of a borrower's assets after the borrower encounters financial problems.

Long after the loan closed, this borrower and its lender got into a fight over which management company should manage the property. The lender claimed that the borrower's efforts to engage or retain a management company amounted to the appointment of a "custodian," thus making the guarantor personally liable for the entire loan.

Anyone familiar with loan documents and debtor-creditor law knows that a "custodian" doesn't include an ordinary property manager. To the contrary, sophisticated commercial real estate documents typically go into tremendous detail on property management and selection of a property manager, never suggesting that the existence of a property manager might be considered as the dreaded appointment of a "custodian." A property manager is simply part of almost any transaction involving significant income-producing real estate. That didn't stop the lender from making its claim.

In the same case, the nonrecourse carveout guaranty also made the guarantor personally responsible if the borrower was guilty of misrepresentation. That clause in any guaranty is designed to make the lender whole for certain inaccuracies in information that the borrower might deliver to the lender during the underwriting process for the loan, or later loan administration. It incentivizes the borrower not to screw around.

Long after the loan closing, when the loan was in distress, the borrower and the lender found themselves in court. The borrower took one position; the lender took the opposite position. The borrower said the lender had done bad things. The lender said the borrower had done bad things.

The lender then claimed in court that the borrower had done even one more bad thing: the borrower's claims in the litigation constituted "misrepresentation," according to the lender. That's because--remember--the borrower and the lender disagreed. That's why they were in court. Because they disagreed and the lender thought the borrower was wrong, the lender claimed the borrower's wrong statements were "misrepresentations," giving the lender the right to go after the guarantor under the nonrecourse carveout guaranty. That's not at all how the concept of "misrepresentations" is ordinarily understood in commercial real estate, but that didn't stop the lender. Under the lender's theory of "misrepresentation," anything the borrower says in litigation—if the lender disagrees with it—could trigger liability under the nonrecourse carveout guaranty.

The guarantor in each of these pending cases now faces substantial exposure if the lender ultimately prevails, plus substantial litigation expense, distraction, and uncertainty regardless of who prevails. In each case, the lender has twisted the words of a nonrecourse carveout guaranty to seek a result that is entirely inconsistent with the words of the guaranty or the marketplace expectations of what those words mean.

Borrowers, guarantors, and their counsel need to think carefully about any nonrecourse carveout guaranty. How can a lender possibly misconstrue the words of that guaranty? Counsel should try to foresee and prevent any misconstruction. How can counsel narrow and limit the guarantor's risks, to prevent any possibility of misinterpretation?

The parties and their counsel need to recognize that courts typically don't understand commercial real estate finance and often don't care about the nuances of how the parties allocated or defined certain risks. Very few commercial real estate or business lawyers become judges. When a judge sees the word "guaranty," that alone may suffice to trigger personal liability, regardless of the terms of the guaranty. And if the guarantor's liability arises only if certain conditions are met, those conditions must be expressed even more clearly and simply than they would obviously need to be.

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