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Stein's Law

The Guarantor's Dilemma

A mortgage lender hates the idea that the borrower might file bankruptcy. Thus, even if the loan is otherwise nonrecourse, the lender will often require the owner of the borrower to sign a "carveout guaranty." Such a guaranty won't activate unless, in part, the owner ever decides to put the borrower into bankruptcy. It gives the owner every incentive to keep the borrower out of bankruptcy. It should solve the lender's concern and prevent voluntary bankruptcies, right?

That dynamic works fine as long as no third parties enter the picture. If the owner owns 100 percent of the borrower and doesn't have to answer to any other investors in the borrower, the owner can do as he or she pleases. The owner can make sure the borrower never files bankruptcy, even if failure to file will let the mortgage lender foreclose on the borrower, take the borrower's only meaningful asset, and put the borrower out of business—a form of corporate suicide.

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If the borrower has other investors, though, the situation becomes more complicated. If the borrower faces a foreclosure sale, then those other investors will want to see the borrower file bankruptcy, as a matter of self-preservation. This also almost means that for any company with any degree of complexity, if bankruptcy is available the company should always choose bankruptcy. Ordinary state-court foreclosure proceedings almost don't matter.

If the controlling owner signed a carveout guaranty, though, the controlling owner may deliberately not pursue a borrower bankruptcy filing. By preventing such a filing, the controlling owner prevents guaranty exposure. The other investors might then claim the controlling investor didn't live up to his obligations as a steward of their company—he let the company commit corporate suicide just to prevent guaranty exposure.

Controlling owners of borrowers and their counsel know how to prevent those claims from investors. They simply require the investors to waive any such claims in advance. If the investors don't want to sign that waiver, then the controlling owner will find other investors.

A case decided in April of this year shows that carveout guarantors may have more to fear than claims from co-investors. The case involved another layer of fallout from the Lightstone Group's doomed purchase, in 2007, of Extended Stay Hotels, using mortgage debt and ten layers of mezzanine debt—each layer backed by a pledge of the equity ownership of the next entity down the ladder, finally reaching a pledge of the equity ownership of the mortgage borrower. David Lichtenstein, the principal of Lightstone, signed guaranties by which he personally agreed to pay $100 million if a voluntary bankruptcy filing occurred.

When the financial crisis started to bring down this tower of debt, Mr. Lichtenstein had to choose between (a) having ESH entities file bankruptcy and (b) protecting himself from guaranty liability. Counsel warned that if he didn't choose bankruptcy, then he would face liability for being a bad steward of the companies he controlled. But those claims would not come from other investors, the expected plaintiffs. Instead they would come, for example, from mezzanine lenders to companies that would become worthless if the mortgage lender successfully foreclosed. And the potential claims of mismanagement and self-interest had no dollar cap.

To prevent those unlimited claims from one category of creditor, counsel told Mr. Lichtenstein he needed to have his companies file bankruptcy to prevent another category of creditor from foreclosing. So he did. This created $100 million of liability on his carveout guaranty. The court concluded that his attorneys gave him good advice. In other words, Mr. Lichtenstein did have an obligation—to other creditors, not to co-investors—to put his companies into bankruptcy. Mr. Lichtenstein has already appealed, but that doesn't mean he will win.

The April decision represents another permutation in the world of nonrecourse carveout guaranties, tangled up even more in this case by the existence of multiple layers of debt. The decision may mean carveout guarantors need to think about demanding new protective language in new places—i.e., mezzanine loan documents or even contracts with ordinary garden-variety creditors. It is unclear just how many unexpected players might parachute into a borrower's capital structure and claim the controlling owner mismanaged the company by not filing bankruptcy.

Maybe carveout guarantors need to put protective language in their LLCs' public charter documents. And they might try to negotiate exceptions in carveout guaranties for circumstances where bankruptcy represents the only reasonable action an LLC can take.

These problems won't necessarily arise in ordinary mortgage loans. Mr. Lichtenstein's problems arose primarily from the existence of multiple layers of mezzanine debt almost equal to the optimistically calculated value of the underlying real estate.

But the case does stand for a larger and more general proposition: surprises never end in the world of nonrecourse carveout guaranties. MO

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