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Tax and Non-Tax Reasons to be Cautious about "Bad Boy Nonrecourse Carve-out Guarantees"

IRS Backtracks on Recent Conclusion that "Bad Boy Guarantees" May Convert Nonrecourse Debt into Recourse Debt but Risks Still Remain

By: Lorne W. McDougall

On April 15, 2016 the IRS reversed its controversial position that bad boy guarantees may convert nonrecourse debt into recourse debt. General Legal Advice Memorandum Number AM2016-001 released April 15, 2016 effectively withdrew Chief Counsel Advice Memorandum Number 201606027 issued on February 5, 2016 which concluded that "bad boy guarantees" may cause nonrecourse financing to become, for tax purposes, the sole recourse debt of the guarantor. Such a result could dramatically affect the tax basis and at-risk investment of the borrowing entity's partners or members that do not provide a guaranty. Nonrecourse liability generally increases the tax basis and at-risk investment of all parties but recourse liability increases only that of the guarantor.

The February 5th IRS Memo concluded that certain events such as voluntary bankruptcy, collusive involuntary bankruptcy, unapproved junior financing and transfers or admitting in writing borrower's inability to pay its debts as they become due were not sufficiently remote so as to satisfy the meaning of Treas. Reg.1.752-2(b)(3) which disregards payment obligations that are subject to contingencies that are unlikely to occur.

Most loan parties believe just the opposite. The fact that the guarantor usually directly or indirectly controls the borrower means that the likelihood of it allowing conduct that would trigger personal liability is extremely remote.

The February 5th IRS Memo seemed to assume that a bad boy guaranty is the functional equivalent of a payment guaranty. But the real purpose of a bad boy guaranty is to discourage those who control the borrower from allowing it to commit certain "bad acts" that are harmful to the interests of the lender. Unlike the case with a payment guaranty, unless the prohibited conduct occurs the guarantor is not liable for payment regardless of what other defaults exist or whether the loan is ever repaid.

A bad boy guaranty merely provides a nonrecourse lender with the leverage to make sure the mortgaged property, usually its only source of repayment after default, remains in good condition, stays free of unapproved liens or transfers and ensures that the borrower does not do anything that will interfere with the recovery of its collateral. Obtaining the right to impose potential recourse liability on those who can prevent these occurrences gives the lender a significant tool to prevent such harm, but falls far short of assuring repayment.

After an industry outcry the IRS reversed its position in its April 15th memo saying that this could only result after "the contingency actually occurs". While the April 15th memo is a welcome retreat from its prior position, the exact wording of each recourse trigger remains critical.

If one of those triggers includes borrower's admission "in writing or in any legal proceeding that it is insolvent or unable to pay its debts as they become due" (language specifically cited in both IRS memos) this contingency may become a reality if the project fails or the borrower becomes insolvent since the borrower will have to make such an admission at some point. Once it does, even under the April 15th memo, the IRS could take the position that the debt has become recourse

which is bad enough, but even worse, the guarantor may now be on the hook to the lender for the entire loan, solely because the borrower eventually had to admit its insolvency.

Revising the language cited by the IRS to read substantially as follows might avoid such a result:

Borrower admits, in writing or in any legal proceeding that it is insolvent or unable to pay its debts as they become due (other than at the request of Lender or Lender's agents or employees, in any financial statement or information provided pursuant to the Loan Documents, or unless such admission is true when made).

The additional language significantly narrows the scope of the contingency and a truthful admission of insolvency no longer triggers personal recourse against the guarantor.

In addition to the tax point discussed above, recent court cases provide additional reasons to be concerned about inartfully drafted bad boy guarantees.

In Wells Fargo Bank NA v. Cherryland Mall Limited Partnership, et al., 812 N.W.2d 799 (Mich.Ct.App., 2011) the court held that a borrower's insolvency constituted a failure to maintain its status as a single purpose entity triggering full recourse liability under the terms of the applicable bad boy guaranty. Other courts have reached similar holdings. It is very unlikely that the guarantor realized it was effectively guaranteeing the borrower's solvency by agreeing to guaranty borrower's SPE status. A lender's definition of what constitutes an SPE is frequently far broader than what rating agencies or courts require. No rating agency or court has ever determined that ongoing solvency is an essential element of SPE status.

Simply inserting the word "**intends**" before a borrower's covenant to remain solvent or excluding that element of lender's definition of an SPE in a bad boy guaranty can prevent unexpected personal liability if the project is unsuccessful.

Another common bad boy recourse trigger is the occurrence of "waste" at the property. In Travelers Insurance Company v. 633 Third Associates, et al, 14 F. 3rd 114 (2nd Cir. 1994), the court held that the borrower's failure to pay real estate taxes constituted waste and triggered recourse under a bad boy guaranty prohibiting waste. Limiting liability to physical waste not resulting from borrower's lack of funds may avoid a surprise such as this.

Recourse liability can also be triggered for (i) a voluntary "Lien"; (ii) an unapproved "Transfer"; or (iii) incurring additional Indebtedness. If these terms are not properly defined unintended consequences can result. For instance, adding the words "resulting from the consent or acts of the Borrower" to the definition of "Liens" can eliminate liability for a tenant's mechanics liens or other statutory liens because such liens are not created with the consent or acknowledgement of the borrower. Transfers can also be limited to affirmative acts of the borrower and avoid those that occur by operation of law. Adding an exception for trade debt incurred in the ordinary course of business can minimize guarantor's exposure for additional indebtedness.

A lender's "standard" bad boy nonrecourse carve-out language can be a trap for the unwary and result in often unintended personal liability and/or adverse tax consequences. Careful drafting can help avoid both results.

Lorne W. McDougall | 617-951-2287 | lorne.mcdougall@lockelord.com