

## GUARANTEE LIABILITY WITH MEZZANINE LOANS AND MORTGAGES

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With mezzanine financing, there is a potential guarantee liability to the principals of the developer that they may not foresee. The issue arises in a financing that has a mortgage loan with springing guarantees combined with a mezzanine loan secured by a pledge of interests in the mortgage borrower.

Generally, the principals of a mortgage borrower give a bad boy springing guarantee to the mortgage lender. The principals agree to be personally liable for the mortgage loan if the borrower declares bankruptcy or does other "bad" things. Principals of the borrower give these guarantees because they control the borrower and have an economic interest in the borrower. They are essentially agreeing that in exchange for a non-recourse loan, they will not fight the lender's efforts to take the collateral if the loan defaults.

The problem arises when the mezzanine lender forecloses on the pledge of interests in the mortgage borrower. After foreclosure, the mezzanine lender controls the mortgage borrower. Meanwhile, the springing guarantor has lost its economic interest in and management control of the mortgage borrower, but still has the liability under the guarantee for "bad acts" of the mortgage borrower.

If there is a mezzanine loan that goes into default, followed by a foreclosure by the mezzanine lender, the mezzanine lender controls the borrower, not the guarantor. The mezzanine lender can then threaten to bankrupt the mortgage borrower and trigger the personal liability for the mortgage debt. In the end, the guarantor may be forced to repay the mezzanine lender on its loan; in effect, the mezzanine loan had become a recourse obligation.

Mezzanine borrowers/bad boy guarantors should require the mezzanine lenders to obtain either (i) a release of the bad boy guarantor from the mortgage lender (usually by replacing the bad boy guarantee with one from the mezzanine lender) or (ii) an appropriate indemnity from the mezzanine lender for liability under the bad boy guarantee that the mezzanine lender creates post foreclosure. In each case, this should be a condition to permitting the foreclosure of the mezzanine position.

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