Restructuring a Loan With a Third-Party Personal Guarantor

This article explores the circumstances that lead to an investor/guarantor becoming liable on a personal guaranty, the issues the guarantor will need to have addressed when discussing restructuring and loan modification options with the lender, the various legal and tax considerations that come into play for all parties, and the strategies the guarantor is likely to consider—and that the lender should be prepared to deal with.

LAWRENCE J. FELLER, KRISTIN L. DUNLAP, AND KENNETH KLASSMAN

In today’s economy, more and more real estate investors are finding themselves in the situation where they have personally guaranteed a loan on a real estate deal that is not performing. The investor/guarantor is now faced with a situation where he or she has personal exposure to the lender and the other investors/partners in the deal, often in an amount that greatly exceeds the value of the assets of such investor. This article, by means of analyzing a hypothetical loan transaction and its denouement, explores the circumstances that lead to an investor/guarantor becoming liable on a personal guaranty, the issues the guarantor will need to have addressed when discussing restructuring and loan modification options with the lender, the various legal and tax considerations that come into play, and the strategies the guarantor is likely to consider if placed in this precarious position.

LOAN SCENARIO

There are many different ways a person may find him- or herself personally liable to a lender or the other investors/partners on a real estate deal. The following is just one scenario typical of those that are playing out for real estate investors and their lenders all over the country today.

In 2006 a real estate entrepreneur identified a piece of commercial real estate in a second-tier market that appeared to have the appropriate demographics to support the redevelopment of the property into a higher performing center. The entrepreneur purchased the property at a seven cap (i.e., seven times capital- ization), which was, and still is, by general standards, believed to be a fairly good deal in the marketplace. The center was 30 percent vacant, but the entrepreneur was accepting of this fact because the intent was to re-tenant the center with higher paying, more creditworthy tenants, stabilize the center, and re-sell the property a few years down the road at a five cap. The entrepreneur was excited about the opportunity and decided to invest his own capital, and also to bring in a few close friends and family members to invest. The entrepreneur and the investors organized a limited liability company (LLC) to acquire the property. As part of the financing package, each of the investors was asked to sign a personal guaranty, in favor of the mortgage lender. Believing there was not any real risk that the guaranty would ever be triggered, each investor agreed to sign.

At the time of acquisition, the LLC borrowed $3 million to acquire the property. Over the course of the next two years, the LLC, as a result of renovations to the property, increased the debt to $5 million. In 2008, the commercial real estate market stagnated, several tenants left the property and now there was no market for replacement tenants—leaving the...
center 50 percent vacant. The LLC owes the lender $5 million in principal, which has started accruing interest at default interest rates since the LLC can no longer afford to keep current on the loan. The most recent appraisal of the property puts its value at approximately $3 million. Accordingly, each investor faces joint and several liability to the lender of approximately $2 million, assuming the property can even be sold at its current value. The entrepreneur who put the deal together also faces personal liability on several other deals that have gone bad. Some of the investors have liquid assets that would cover the entire $2 million obligation, while others are teetering on the edge of bankruptcy.

UNDERSTANDING THE PARTIES’ POSITIONS
The general rule that applies to this situation and others like it is that there is no single solution. In order to effectively determine the best course of action once a guarantor group realizes that it owns an asset that is worth substantially less than the debt owed to the lender, the group needs to evaluate all factors relevant to its situation. This is exactly what the lender should also be doing—if it is not, then this will allow the guarantor group to be one step ahead.

The Property. One of the lender’s primary concerns, if not the most significant, is evaluating whether the current owner/operator is the right person to carry out the day-to-day operations at the property. If the loan is in default, the lender has the right to foreclose on its mortgage and legally compel the removal of the operator or put a receiver in its place. To the extent that the operator is also a guarantor, that person should have an interest in retaining his or her position as the operator, in order to be able to maintain and improve the collateral value of the property, thereby minimizing and, with any luck, avoiding any personal liability under the guaranty. For this reason, it behooves the operator to stay in frequent contact with the lender once a loan goes into default, including being responsive to the lender’s requests for information.

The lender will want detailed information as to the steps that the operator is taking to improve the value of the collateral. This will allow the lender to assess whether its interests are best served by continuing its relationship with the operator versus removing the operator and bringing in more qualified personnel, typically a third-party receiver. A receiver will have different incentives than a guarantor with respect to the asset and the loan, and this can be costly to the LLC and the guarantor group.

The lender and its independent consulting firm, if any, will also need to understand: (1) the current state of the marketplace in which the property is located, (2) the competition within the marketplace, (3) the competitive advantages and disadvantages of the property, and (4) how the operator is marketing the property in order to insure that the operator is maximizing the strengths and minimizing the weaknesses of the property. The operator-guarantor’s goal in all of this is to show the lender and the independent consulting firm that the operator fully grasps the seriousness of the situation, has a well-thought-out and well-reasoned plan, and has a realistic chance of being successful within a time frame that is acceptable to the lender.

The Loan Documents. Both the guarantors and the lender should review the loan documents, with their attorneys, to assess the nature and extent of the guarantor’s liability to the lender. (Of course, this should have been done at the inception of the loan, but the situation is now different than it was when the project was initiated.) It is critical to review and confirm the terms of the guaranty document. For instance, is the guaranty a guaranty of payment and performance, or just a guaranty of collection? A guaranty of payment and performance creates an obligation of the guarantor upon a default by the borrower whether or not the lender has pursued collection from the borrower, but a guaranty of collection binds the guarantor only after all attempts to obtain payment from the borrower have failed.1

Extent of Liability. Each party should also review the guaranty documents to determine the extent of each guarantor’s liability to the other guarantors, and how that may impact the lender’s options. For example, a joint and several guaranty among all guarantors, as in our hypothetical scenario, means that the lender can pursue any one or all of the

guarantors for the full amount owed to the lender. A guaranty that is several, but not joint, means the lender can pursue each guarantor only for its respective obligation. This is most common in syndicated or participation loans.

A guaranty may also be limited in any number of ways, including:

- A maximum dollar amount;
- A limited enforcement period;
- A specified event, such as a threshold occupancy; or percentage of the property sold; or certain “bad boy” acts of the guarantor, such as fraud, bankruptcy, handling of project funds or misrepresentation concerning the loan (and which are discussed in more detail below).

If there is a joint and several guaranty among all guarantors, the lender can pursue any one or all of them for the full amount owed; on the other hand, with a guaranty that is several, but not joint, the lender can pursue each guarantor only for its respective obligation.

In the absence of any limits, the guaranty is typically full recourse to the guarantor without exception. In addition, in many real estate deals, each guarantor will be held fully responsible for environmental liabilities (no matter the limitation of the guaranty), so the extent of this potential liability will need to be fully re-evaluated (again, it should certainly have been explored at the project’s inception) if there are environmental concerns with the property.

How Guaranty Terms May Affect Negotiations. If a limitation does exist, the parties should determine the scope of the limitation, as any limitation will most likely play into the guarantor’s strategy when dealing with the lender, and vice versa. For example, if a guaranty is limited to a certain amount of principal plus corresponding interest, plus any fees incurred by the lender to collect such amounts, one strategy may be for the guarantor to propose to pay the limited portion of the principal amount in full in exchange for complete forgiveness of the interest and fees incurred by the lender. Ultimately, the guarantor’s decision whether to remit payment to the lender will depend upon a number of factors including the value of the collateral relative to the outstanding balance of the loan, the financial position of the guarantor, the financial position of the other guarantors, and the existence or non-existence of a contribution agreement. The lender’s financial position will also play into the guarantor’s strategy. In today’s environment, many financial institutions are taking their last gasps and trying to get as much money in the door as they can as fast as they can, which may put the guarantor group in a better position to minimize its exposure.

“Bad Boy” Guaranties. When reviewing “bad boy” guaranties it is important to fully understand the circumstances that convert the obligation to a full recourse guaranty. For instance, a misrepresentation of the guarantor’s financial position could be a trigger making the guaranty full recourse. If this is the case, the guarantor should be extremely mindful of making sure that he or she is fully and accurately disclosing all his/her assets and liabilities. To the extent the document holds the guarantor liable for items such as the return of security deposits to the lender, pre-paid rent, real estate taxes, and insurance proceeds, the guarantor should make sure to adhere to the strict requirements of the guaranty and that appropriate procedures exist to make sure that the party responsible for handling the cash for the operator does not create additional liability for the guarantor.

Another issue that arises with “bad boy” limited guaranties is that, if multiple guaranties were delivered to the lender, it is possible that the action of a co-guarantor or the borrower (which may not be controlled by the guarantor) could cause a guarantor to become liable under its guaranty including potentially becoming fully liable for the entire loan balance. For instance, say one of the co-guarantors is the manager of the LLC and takes monies from the LLC operating account and uses it for his or her personal uses. This fraudulent act would constitute a “bad boy” act and therefore trigger a fully recourse guaranty, at which point all of the co-guarantors are jointly and severally liable for the loan. These dynamics should be fully understood by the guarantor when deciding its next steps with respect to the lender and the co-guarantors. And, of course, the lender on its part should similarly carefully assess whether any guarantor misstep has been made which will enable the lender to collect in full.

Rights and Obligations Among Co-guarantors Under Partnership Documents. In many cases, the guarantors will have entered into an operating agreement or some other type of partnership agreement which sets forth various rights and obligations with respect to each other and which will greatly affect the outcome of the guarantors’ negotiations with the lender and each other. For instance, it is possible that the partnership
documents may specifically address the circumstance in which the guarantors become personally liable to the entity’s lender. If this is the case, the partnership documents might identify the responsibility of each guarantor as to the other guarantors and the penalties for not complying with such obligations. The guarantor obviously needs to be aware of the consequences of not complying with the terms of the partnership documents. It is also important for the guarantor to understand that, subject to any legal rights and obligations that might apply by operation of law, the partnership documents govern the rights and obligations among the guarantors themselves, but not the relationship between the guarantors, on the one hand, and the lender, on the other hand. Accordingly, the guarantors have to keep in mind both the rights and obligations provided for in the partnership documents and how those rights and obligations come into play in light of any action the lender may take against the guarantor group. For instance, the partnership documents may provide that each guarantor is responsible for a share of the ultimate liability to the lender consistent with its investment interest in the entity. However, if the guarantors have executed joint and several guaranties with the lender, the lender will likely pursue all guarantors and seek payment from any guarantor that has the financial capacity to make the lender whole. Accordingly, the rights and obligations under the partnership documents with respect to each member/guarantor vis à vis the others may only come into play once the lender has collected all of the indebtedness owed to it.

Another issue that is likely to be addressed in the partnership documents is who controls the decision making of the borrowing entity. This is particularly relevant because in a typical real estate transaction each guarantor is required to be responsible for the obligations incurred by the borrowing entity, no matter if such guarantor participated in the creation or modification of such obligations. For instance, the borrowing entity is the party that, with the lender’s consent, has the right to extend the loan; increase the indebtedness incurred by the borrowing entity; make day-to-day decisions concerning the property such as whether or not to pursue a particular tenant at the property and, if so, on what terms; and whether or not to sell the property including, potentially for an amount which is less than the indebtedness owed to the lender. All of these events can greatly impact the liability of each individual guarantor. A properly drafted guaranty would not allow a guarantor to escape liability simply because the guarantor did not participate in a particular decision of the borrowing entity or perhaps was unaware that the decision was even made and in most cases will expressly disclaim these types of defenses. The guarantor’s liability would be applied in the same manner notwithstanding the borrowing entity’s legal structure (LLC, general partnership, corporation). Accordingly, in many regards, the guarantor becomes beholden to the parties who have decision making authority on behalf of the borrowing entity.

Sometimes the partnership documents will permit the removal of a decision maker. If such a provision exists, it should be carefully reviewed and evaluated by each guarantor prior to negotiations with the lender. It may become readily apparent that the interest of the decision maker of the borrowing entity is not necessarily aligned with the interest of the guarantor group as a whole. One example is if the decision maker happens to be an individual with little to no personal assets, but who is entitled to tremendous upside if the project can be repositioned. This decision maker may be incentivized to take bigger risks to position the project, such as incurring additional indebtedness on behalf of the borrowing entity, on the presumption that he has nothing to lose. This presents a dangerous position for the other guarantors. Even if the operating agreement does not provide for the removal of the decision maker, it may be appropriate for the guarantor group to discuss an amendment to the operating agreement which will allow for greater participation by the guarantor group as a whole in decision making.

**Contribution Rights Under Common Law.** Carefully drafted partnership documents are also important with respect to the rights and obligations a co-guarantor may have against the other co-guarantors so as to not leave the remedies up to the courts. Even if the guarantors have not entered into an express agreement setting forth their respective responsibility for a jointly and severally guaranteed debt, the law may provide a common law right of contribution (e.g., Illinois, where..."
the authors practice, has such a right\(^3\)). Under this right, the co-guarantors become liable to contribute their proportionate share of the amount paid to the lender, provided a co-guarantor is not insolvent, in which case the insolvent co-guarantor is not included in determining the proportions. As a general rule, the right to contribution from co-guarantors does not arise unless and until there is a default (as determined by the underlying loan documents). When given the choice, a guarantor should prefer to have the contribution rights and obligations definitively set forth in an agreement, rather than to hope that common law rights and obligations will apply and protect such guarantor.

GUARANTOR’S APPROACH TO LENDER

Once they understand their position(s), the guarantors need to consider how best to approach the lender. What can they say to a lender? When and how should they get their attorney(s) involved? Does each guarantor need separate counsel? These are very important questions that can have a huge impact on discussions among the guarantors themselves and, ultimately, on discussions with the lender. Although this section of the article considers only a guarantor’s point of view, it is imperative that lenders (1) understand “where the borrower/guarantor is coming from,” and (2) anticipate the complications different guarantor positions may bring to the negotiating table.

What Can the Guarantor Say to a Lender? Best practices dictate that a guarantor mark any written communication to the lender with “For Settlement Discussion Purposes Only.” Although offers of settlement or compromise are generally not admissible at trial to prove liability, such offers can be admissible if the statements made by a party during settlement negotiations are inconsistent with that party’s position during the trial, or if the statements are being used to prove the existence of a binding settlement agreement. Furthermore, to the extent that a statement made during settlement negotiations is used to show something other than liability, such as witness bias, the statements would be admissible within the discretion of the judge.\(^4\)

---

\(^3\) Harris v. Handmacher, 185 Ill. App. 3d 1023, 1026-1027, 542 N.E.2d 77, 80 (1989); McDavid v. McLean, 202 Ill. 354, 357, 66 N.E. 1075, 1076 (Ill. 1903).

another guarantor, who is responsible pursuant to the contribution agreement to fund the significant portion of such recapitalization, may view the lender’s request for additional capital or collateral as an invitation to throw good money after bad. This is particularly likely if such guarantor has limited liquid funds, and therefore prefers to push back on the lender’s request for additional capital or collateral.

Accordingly, even when it might seem that the interests of the guarantors are aligned there are several circumstances whereby the interests of the guarantors and how they may want to handle a particular demand may differ. This issue highlights the importance of the decision making on behalf of the borrowing entity. If decision making is based on a majority of ownership and ownership of the entity was consistent with the sharing percentages set forth in the contribution agreement, the guarantor who is responsible for the most significant portion of the recapitalization might be able to dictate that the borrowing entity would not agree to any such amendments. While it is important to point out that decision makers in the borrowing entity likely have fiduciary duties to the borrowing entity and its owners, which requires that the decision makers make decisions in the best interest of the borrowing entity and its owners, such decision making authority would likely be protected by the business judgment rule. So long as such decisions are premised on valid business reasons, which typically are not difficult to establish, the decision maker will be protected.

**Does Each Guarantor Need Personal Counsel?** Given the conflicts that can arise among the guarantors as a whole it may be prudent for each guarantor to retain separate counsel to ensure that individual best interests are being served. This counsel can not only advise the guarantor on his or her rights with respect to each of the guarantors but can also assist the guarantor on more personal matters such as asset protection planning. Any asset protection that would take place in light of liability posed by the guarantor’s guaranty to the lender must be conducted subject to applicable fraudulent conveyance laws.1 To the extent the guarantor has assets that exceed the guarantor’s contingent liabilities there is still an opportunity to protect those assets.

---


---

**TAX CONSIDERATIONS**

**Guarantors’ Concerns.** Further complicating the guarantors’ negotiations with the lender are the tax effects of any proposed modifications (or cancellation) to the loan documents. The tax concepts surrounding this type of default scenario are complex and vary greatly depending on the facts. This is also another issue that each guarantor may need to determined on an individual basis. The following summarizes the basic tax concepts involved. It behooves a lender that is negotiating with guarantors of a failed loan to understand the tax issues of concern to them.

If the lender agrees to reduce the principal balance of the loan, this principal reduction will result in the recognition of cancellation of indebtedness (COD) income to the borrower, which is taxable as ordinary income in an amount of the principal reduction. Section 108(a) of the Internal Revenue Code provides a number of exceptions to the taxation of COD income. The exceptions that are most likely to apply are the bankruptcy, insolvency, or qualified real property business indebtedness exceptions.4 Note that if the borrower is a partnership or an LLC taxable as a partnership, insolvency is tested at the partner or member level.

The amount paid by the guarantor on its guaranty will either be treated as a capital contribution by the guarantor to the borrower or will be deductible by the guarantor as a bad debt deduction.7 If the payment is deductible by the guarantor as a bad debt deduction, the character of the deduction will increase the guarantor’s basis in his or her interest in the borrower.8 If the payment is deductible by the guarantor as a bad debt deduction, the character of the deduction will depend on whether the bad debt is treated as a business bad debt deduction or a non-business bad debt deduction. A business bad debt is
deductible against ordinary income whether or not the debt is totally or partially worthless. A non-business bad debt is deducted as a short term capital loss and must be totally worthless. The character of the bad debt deduction as business or non-business will depend on whether or not the obligation was made in connection with the guarantor’s trade or business. This determination is highly dependent on the particular facts and circumstances. However, if the main purpose of the guaranty was to protect or increase the guarantor’s investment in the borrower, the bad debt will be considered a non-business bad debt. In any event, to the extent that there is a right of subrogation against other guarantors, the bad debt deduction may not be taken until such right becomes worthless.

Regardless whether (1) the borrower transfers the property to the lender by giving it a deed in lieu of foreclosure or (2) the lender forecloses on the property, the transfer of the property to the lender is treated for tax purposes as a sale of the property to the lender and the borrower will recognize income or loss to the extent that the outstanding balance of the debt exceeds the borrower’s basis in the property. However, if the debt is considered recourse debt as a result of the guaranty, the borrower may recognize COD income (unless one of the exceptions applies) equal to the difference between the principal amount of the debt and the fair market value of the property. In such a case, the borrower would also recognize gain or loss equal to the difference between the fair market value of the property and the borrower’s basis in the property. If this transaction results in a capital loss to the borrower and the borrower does not have sufficient capital gains to offset this capital loss, this could result in the borrower paying income tax on the ordinary COD income and leaving the borrower with a currently nondeductible capital loss.

Further complicating matters, the American Recovery and Reinvestment Act of 2009 (ARRA) added new Section 108(i) to the Code. At the election of the taxpayer, Section 108(i) defers the recognition of COD income with certain repurchases, modifications, and exchanges, referred to as “reacquisitions” of “applicable debt instruments” after December 31, 2008, and before January 1, 2011. The election is irrevocable and is made by the entity and not by its partners or shareholders, which may be beneficial to one guarantor but not all of the co-guarantors. The deferral is up to five years. At the end of the deferral, the taxpayer must include the COD income ratably over the next five years. A “reacquisition” includes a complete forgiveness of the indebtedness by the holder of the debt instrument and an “applicable debt instrument” includes any “debt instrument” issued in connection with the conduct of a trade or business.

However, if a taxpayer elects the Section 108(i) deferral, none of the Section 108(a) exceptions can apply with respect to the applicable debt instrument. Due to the complexity of the qualifications and the fact that the election is made at the entity level rather than the partner or shareholder level, the co-guarantors as a group will have to weigh the pros and cons of electing to defer the COD income.

**Lender’s Concerns.** The reduction of the principal balance of the loan should result in a bad debt deduction to the lender. Similar to the treatment of a guarantor discussed above, the character of the deduction will depend on whether the bad debt is treated as a business bad debt deduction or a non-business bad debt deduction. If the bad debt is treated as a business bad debt, it is deductible against ordinary income whether or not the debt is totally or partially worthless. If the debt is treated as a non-business bad debt, it will most likely not be currently deductible if the debt was only reduced in part, since a partial reduction of the debt should mean that the debt is not totally worthless. However, if the debt was totally worthless, the bad debt deduction would result in a short term capital loss.

Any applicable entity that forgives $600 or more is required to file a Form 1099-C with the Internal Revenue Service and provide a copy of such form to the borrower. An applicable entity is defined by:

- IRC § 6050P.
- 14 P.L. 111-5 (signed into law on February 17, 2009).
- 15 Note that certain banks and financial institutions are allowed to use a reserve method for accounting for bad debts.
as (1) “an executive, judicial, or legislative agency,”\textsuperscript{17} and (2) an “applicable financial entity.” The term “applicable financial entity” means (a) any financial institution\textsuperscript{18} and any credit union; (b) the Federal Deposit Insurance Corporation, the Resolution Trust Corporation, the National Credit Union Administration, and any other federal executive agency\textsuperscript{19} and any successor or subunit of any of the foregoing; (c) any other corporation which is a direct or indirect subsidiary of an entity referred to in subparagraph (a) but only if, by virtue of being affiliated with such entity, such other corporation is subject to supervision and examination by a federal or state agency which regulates entities referred to in subparagraph (a), and (d) any organization a significant trade or business of which is the lending of money.

**CONCLUSION**

Un fortunately it seems that every day another real estate deal goes bad. Every investor hopes that it is not his or her deal that tanks, but if so, there are steps that investors can take to minimize the damage. And the mitigating steps that investor-borrowers—especially those who are guarantors of loans—take will have an impact on lenders’ success in recovering as much as possible on sour loans. Although the facts of every deal are different, the key is to apply those facts to the legal and tax considerations involved—with respect to the lender and to the guarantor or co-guarantors—so that the best possible strategy can be determined and the precarious situation that investors may find themselves in can be resolved in a manner that is beneficial to all parties.

\textsuperscript{17} As defined in 31 U.S.C. § 3701(a)(4).

\textsuperscript{18} As described in IRC § 581 or 591(a).

\textsuperscript{19} As defined in IRC § 6050M.