Snatching Retreat from the Jaws of Rout

Guaranteeing a bad real estate debt doesn't guarantee financial disaster.

By **Dean Gloster** and **Matt Lewis**

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In real estate, the personal guaranty is pervasive. The loans it backs are the industry's lifeblood, allowing investors to buy, build and improve residential and commercial projects. In up markets, debt can leverage a small slug of equity into a huge return. But in a recession and credit crunch, leverage multiplies losses. Asset values decline, cash flow won't pay debt service, and there is no replacement financing.

That is where tens of thousands of developers, owners and investors find themselves today. Their equity is lost, and their exposure on guaranties is many times their net worth. They risk owing immense debts after already losing everything.

But all is not lost. Many guarantors are settling their obligations on personal guaranties at a discount or negotiating for time or to share upside as the market turns again. The key is to understand what a lender wants and needs, what lender and borrower alternatives there are and when to make a deal. For borrowers, the best time to deal is when things appear most dire; for lenders, the best time is early, so they are among the first creditors to cut a deal while there are still assets to obtain.

In one of our typical engagements, a residential real estate developer had guaranteed more than $50 million in loans in connection with six projects under development or construction. Upon retirement, he turned over day-to-day operation of the business to young executives not on the hook for guaranties. He was also responsible, under indemnification agreements to a bonding company, for finishing site work at several project locations. By late 2009, all six projects were in trouble, the loans were in default, and the bonding company was suing for more than $5 million.

Creditors get guaranties and indemnity agreements for two reasons: first, as a means of collection if the project entity can't pay; second, to focus the attention of principals when things get difficult. Almost all guaranties include an attorneys' fees provision, requiring payment of the creditor's attorneys fees in a successful collection action. Under California law, most defenses to enforcement of a guaranty can be waived up front and commonly are. But for a guarantor who owes $50 million, not having the money is an effective practical defense to paying the obligations.

Litigating is expensive and despite the attorneys' fees clauses lenders and bonding companies are often unwilling to pay huge legal costs only to gain paltry recoveries after judgment. Many categories of assets—like IRAs, Keoghs, 401(k)s and other retirement plans—are largely exempt from creditor levy. And under federal wage-garnishment laws, the most all creditors combined can get from future salary—after a judgment—is 25 percent of take-home pay. Lenders also face the risk that after months of litigation, the guarantor will file bankruptcy before judgment.

Lenders and bonding companies also often have another agenda, such as getting environmental issues addressed before foreclosure, getting the property back without the delay of a borrower bankruptcy, getting the entitlements extended or getting help with resolving contractor claims. Guarantors therefore have something to trade for a release from a guaranty. Armed with a financial statement and liquidation analysis showing which assets are exempt from judgment levy, a debtor can approach a creditor with compelling facts. When the guarantor is left with an incentive and opportunity to be successful in the future as the economy improves, he or she can also negotiate to share part of that upside, possibly giving creditors more than asset liquidation.

For our guarantor client, one of his largest lenders provided a release in return for a deed in lieu of foreclosure. After mediation, the bonding company settled for specific cooperation and a cash payment of less than one cent on the dollar. Another lender agreed to essentially mothball two projects to wait for the market to come back. A final lender on multiple projects is agreeing to a smaller payment in three years (when there may be more liquidity) and a stipulated judgment (to save attorneys fees) in full satisfaction of the guaranty obligations. Although all of this created difficulty for the guarantor and his wife, and he did have to go back to work in a follow-on business, they were able to keep their house and have peace of mind.

The weakness in the traditional model of sponsor guaranties backing multiple real estate secured loans is that at the bottom of a market cycle—the time lenders most need them—guaranties are often uncollectible. At the same time, the guarantor can find many decades of success wiped out in one bad year. Some of these weaknesses are addressed by emerging alternatives—cross-collateralized loans on separate projects, specific limited dollar amount guaranties and bad boy guaranties that kick in upon specific misconduct or borrower bankruptcy. But the traditional unlimited personal guaranty has not gone away, and in hard economic times, lenders and guarantors need to be practical, prompt and creative in cutting deals to make the best of a difficult situation. ■

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