Bearing the Weight of Stabilization: An Introduction to Carry Guaranties (Part 1)

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Authors:

Joshua (Josh) D. Brock

Geoffrey M. White

Every property costs money to own: real estate taxes accrue, insurance premiums come due, loan interest must be paid, and the building has to be operated and maintained, all regardless of whether the asset is yet generating a dime of income. These unwavering expenses are known as “carry costs.”

When seeking to finance certain kinds of properties, an issue can arise when the asset is not anticipated to generate enough cash flow to cover carry costs during some portion of the loan term. This issue arises on construction loans, but also other transitional financings, such as bridge loans between construction and stabilization (the time when a property reaches its anticipated level of sustainable performance), loans involving significant renovation or repositioning of the property, or assets that otherwise expect to have a ramp-up period in performance.

In such loans on pre-stabilization assets, lenders may address this gap by requiring some combination of reserves for carry costs and/or a personal guaranty from the sponsor for the payment of carry costs, referred to as a “carry guaranty.” A carry guaranty bridges the lag between the time when carry costs start to accrue and when the property generates sufficient income by putting a creditworthy party on the hook for the shortfall until the stabilized asset can carry itself. Although commonplace, the carry guaranty is often one of the most significant recourse obligations in an otherwise nonrecourse financing. This makes the scope and duration of carry guaranties important considerations for both lenders and sponsors.

This introductory post focuses on the basic structure and function of a carry guaranty. Future posts will examine negotiation points, tender rights, and carry obligations embedded in broader recourse guaranties.

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What Carry Guaranties Cover

A carry guaranty is a recourse obligation where the creditworthy sponsor (or an affiliate) personally guaranties the cost of "carrying" the property during the loan term. These carry costs are the recurring costs of owning and operating the asset, including the costs necessary to keep the property in good standing and protect the lender's collateral. Carry guaranties typically cover:

- Debt service and interest, at the applicable or default rate
- Real estate taxes
- Insurance premiums
- Operating expenses
- Required deposits into reserve accounts

Carry guaranties are distinct from other forms of credit support commonly found in commercial real estate finance. They address the risk that a property cannot fund its ongoing carrying costs, which matters because unpaid taxes, lapsed insurance, and unfunded operating expenses directly affect the lender's collateral. Other risks, such as principal repayment and completion of the project, may be separately addressed through repayment guaranties, nonrecourse carve-out guaranties, and completion guaranties. Whether the carry obligation is documented in a standalone carry guaranty, is incorporated into a broader recourse guaranty, or is documented indirectly through an obligation to replenish a carry cost reserve is a critical structural issue. [We will address that distinction in a later post.]

Transactions That Commonly Require Carry Support

Carry guaranties are most common in financings where the property has not yet reached stabilization:

- Bridge and value-add loans, where income is temporarily suppressed during repositioning
- Construction loans, where the asset is not yet producing operating income

- Unstabilized properties, including lease-up multifamily projects and ground-up developments

As a general rule, if the property's business plan and the underwriting of the loan depend on future increases in performance rather than current cash flow, lenders will expect some form of carry support.

Borrowers should also be aware that, while carry guaranties are often explicit and covered by separate agreements, there may be obligations that effectively operate as hidden carry guaranties. The most common scenario would be a reserve for operating expense shortfalls which the borrower is obligated to replenish if the reserve falls below a certain threshold. If this is coupled with a guarantor obligation to satisfy reserve deposits, it becomes effectively a carry guaranty, and the terms of that obligation should be negotiated in the same manner as a true carry guaranty.

Considerations in Negotiation

Many commercial real estate loans are structured as "nonrecourse," meaning the lender looks to the property and not the sponsor's personal assets for repayment, subject to certain exceptions (see our prior discussions of nonrecourse guaranties). The carry guaranty is one of those exceptions, a slice of true personal liability carved out of a generally nonrecourse deal. That is why its scope and duration are negotiated so closely: it is one of the few places a sponsor's own balance sheet is genuinely exposed.

Most carry guaranties are negotiated around similar points. The parties typically negotiate over what is properly considered a carry cost, whether reserve balances offset the exposure, what financial covenants the guarantor must maintain, and when the obligation ends, among other things. Unlike many other kinds of guaranties, carry guaranties are not only relevant in the event of a hypothetical future loss or issue at the property. Rather, they backstop costs that everyone already expects to be incurred, month after month, throughout the transitional period. That makes a carry guaranty less a hypothetical safety net than a live, anticipated obligation, which is a large part of why the parties negotiate it so hard.

The next post takes up those issues in more detail, especially the termination mechanics that often matter most in practice. For now, if you have questions about this article or would like further guidance on carry guaranties as they apply to a specific transaction or lending scenario, please contact the authors or any member of the firm's Commercial Real Estate Finance team.

**Peyton Cuzzart, a student at the University of Louisville Louis D. Brandeis School of Law, contributed to this article while working as a summer associate at FBT Gibbons.*

The Carveout

A legal blog geared toward sophisticated capital market participants, The Carveout provides insight into current trends and developments in commercial real estate finance (CREF)—with a particular focus on non-recourse carveouts and CREF loan platforms including CMBS, debt funds, private capital, REITs, life insurance companies, and other complex sources of capital.

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