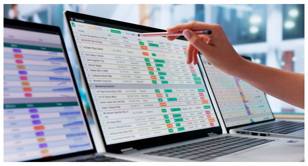

Balancing the Load: Negotiating Key Issues in Carry Guaranties (Part 2)

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As discussed in our prior post, carry guaranties are a key component of many kinds of real estate financing transactions and generally require the guarantor to be responsible for some combination of debt service, taxes, insurance, operating expenses, and reserve obligations where operating cash flow is not projected to be sufficient to easily cover such items at closing. The parties may negotiate a number of items, such as which costs and expenses are appropriately included as "carry costs," whether reserve balances offset the guarantor's exposure, whether the obligation is capped, what financial covenants apply, and whether the guaranty burns off after completion or stabilization. Those terms define the basic scope of the underlying obligation and are typically given significant consideration because they meaningfully impact the guarantor's obligations.

In a distress scenario, however, the most consequential issue is often the duration of the obligation. Carry costs accrue over time, and the obligation may remain in place after the sponsor has lost control of the asset and, without specific terms to the contrary, may continue indefinitely. For that reason, termination mechanics (principally any sunset provision and tender right) are often the provisions in the document which receive the most negotiating effort. The rest of this post focuses on those mechanics.

Open-Ended Guarantor Exposure

Consider a loan that is in default. Rather than foreclose immediately, the lender may have a receiver appointed to run the property, may replace the property manager or may otherwise exercise some operational rights over the property. The sponsor no longer controls the asset or its cash flow, but the carry obligations continue. Each month, taxes, insurance, and operating costs come due, and the guarantor remains liable for them.

Without a sunset or tender mechanism, there may be no practical endpoint to that exposure. The guarantor would therefore be funding the carrying costs of an asset it no longer controls and may never recover while the lender either works through its remedies or simply delays taking further action given that the carry guaranty is covering those costs in the meantime. Some carry guaranties expressly cover operating expenses incurred even after a receiver is appointed or other remedies are exercised, making the issue more than theoretical. Sunset and tender provisions are designed to determine whether, and under what circumstances, the guarantor can bring that obligation to an end.

Sunset Provisions

A sunset is a set period of time, or a defined triggering event, after which the carry obligation terminates or is capped, regardless of whether the sponsor has surrendered the asset or the lender has taken any action. Where a sunset applies, the guarantor's exposure has a built-in endpoint that does not depend on the lender's cooperation or the sponsor's willingness to tender the asset.

Tender Conditions

A "tender" is the mechanism by which the sponsor may offer to transfer the asset to the lender and, in exchange, obtains the benefit of the carry guaranty's termination provisions. It typically involves a deed in lieu of foreclosure and, in some structures, a transfer of the equity interests in the borrower. By offering the property to the lender (subject to satisfying the conditions as negotiated in the carry guaranty), regardless of whether the lender agrees to accept the property, the carry guaranty obligations will terminate.

Some carry guaranties terminate once the sponsor satisfies the tender conditions and completes the required deliveries. More commonly, the carry obligation survives for a post-tender "tail period," often three to 12 months, during which carry liability continues. The length of that tail and the payments associated with it are often significant points of negotiation and can materially affect the guarantor's exposure.

Lenders typically agree to release or cap an ongoing carry obligation only if the asset is delivered in the manner required by the loan documents and the sponsor satisfies a lengthy series of additional requirements. Whether a tender right provides meaningful protection depends on the sponsor's ability to satisfy the conditions attached to it. While the specifics vary by deal and are often subject to significant negotiation, the list below illustrates the breadth of what lenders typically require:

- A continuing Event of Default and notice to lender of borrower's election to tender the property;
- Delivery of a deed, and, where the structure calls for it, an assignment of 100% of the equity interests in the borrower, conveying good and marketable title;
- Payment of all sums then due, including any existing carry or shortfall deficits and the amount necessary to cover carry costs during the tail period, if applicable;
- An updated Phase I environmental report, and where such report indicates remediation is necessary, a remediation deposit;
- Delivery of a title commitment or qualified title coverage acceptable to the lender;
- Entering into one or more agreements covering the assignment of leases, service contracts, permits, reserve accounts, and/or insurance claims;
- Delivery of tenant deposits and prepaid rents, and notices to tenants alerting them to the transfer of the property;
- Organizational documents, which may include Foreign Investment in Real Property Tax Act (FIRPTA) certifications, W-9s, authorizing resolutions and borrower certifications;
- Reimbursement of the lender's out-of-pocket costs, and a release of the lender and its affiliates; and
- Confirmation that neither the borrower nor the guarantor is subject to a bankruptcy or insolvency proceeding.

The Cost and Timing of Release

Tender conditions provide a path out of the carry obligation, but the remainder of the loan documents still determine what it costs to use that path. The defined terms and calculation provisions governing the tender can be just as important as the tender conditions themselves, as they determine both the amount required to complete the tender and when the carry obligation ends.

The cost of the tender and the timing of the release often turn on a handful of key defined concepts, including:

- "**Estimated Carry Payment**" determines the amount required to complete the tender and may incorporate projected carry costs, tail liability, reserve replenishment obligations, and other accrued amounts. In some transactions, the amount is calculated by the lender in its reasonable discretion, while others require supporting calculations or a defined methodology.
- "**Tail Period**" defines the post-tender period during which the guarantor remains responsible for carrying costs after the property has been transferred.
- "**Termination Conditions**" often operate as a second layer of requirements that must be satisfied before a release becomes effective, even after the tender itself has been completed.
- "**Shortfall Reserve Termination Date**" in reserve-based structures may control when replenishment obligations end and, in turn, when the related carry liability terminates.

Ultimately, a carry guaranty is defined not only by what it covers but also by whether sunset or tender provisions offer a genuine, workable way for the borrower to exit the property, which is why these provisions deserve close attention from the outset.

But what happens when the lender refuses to accept a tendered asset or otherwise declines to act? Left unresolved, that scenario can leave the guarantor's carry liability open-ended with no clear path to relief. In a future post, we will cover this very scenario and drafting strategies to mitigate such risks in a mutually workable solution.

For an introduction to the core purpose, structure, and common negotiation points of carry guaranties, refer back to the first article in this series. You can also contact the authors or a member of the firm's Commercial Real Estate Finance team if you have questions about sunset provisions, tender rights, or other carry guaranty issues as they apply to a specific transaction.

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