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Structured Finance Fact Sheet

The Bad Acts Guaranty

The Basics

- In structured finance, Loans are often non-recourse to the Borrower. If a Loan is non-recourse, the Lender can only look to its collateral in order to satisfy the Loan, and the Borrower is not personally liable on the debt.
- However, non-recourse Loans often include certain carve-outs for "bad acts" of the Borrower that will trigger personal liability.
- Lenders also typically require a "Bad Acts Guaranty" from a credit-worthy parent entity of the Borrower to backstop the Borrower's personal liability.
- A Bad Acts Guaranty is a means to ensure that the Borrower complies with the representations and covenants that it has made in the Loan Documents, on which the Lender is relying in making the Loan. A Bad Acts Guaranty also reduces the risk that the Borrower will file a bankruptcy case to delay foreclosure.

How it Works

- The Loan Agreement should include a list of bad acts that, if taken by the Borrower, will trigger personal liability.
- In general, bad acts are actions that would impair the isolation of the Lender's collateral and the cash flow from the collateral, or would make it more difficult for the Lender to recover on the Loan following an event of default. Bad acts should be intentional, willful actions.
- In the Loan Agreement, bad acts generally are split into two categories:
  - (1) Above-the-line triggers make the Borrower and Guarantor personally liable for the Lender's costs and expenses resulting from the bad acts. These bad acts typically include fraud, physical waste of the collateral, misappropriation of funds and a breach of any special purpose provisions.
  - (2) Below-the-line triggers make the Borrower and Guarantor personally liable for the entire amount of the Loan upon the occurrence of the bad act. These bad acts typically include unpermitted transfers of the collateral, a voluntary bankruptcy filing by the Borrower and failure by the Borrower to object to an involuntary bankruptcy filing (unless there is no good faith basis to do so).
- Bad Acts Guaranties generally are not considered credit support for the Borrower, which is important in deals that require non-consolidation opinions.
- Bad Acts Guaranties generally are not considered credit support because (1) the Guarantor is not liable for the debt unless a bad act occurs, even if the Loan is in default, and (2) the Guarantor, as a parent entity of the Borrower, has control over whether the Borrower commits a bad act.

For more information on these issues, contact:

Kathryn M. Borgeson
Special Counsel
+1 202 862 2384

Peter M. Dodson
Senior Counsel
+1 202 862 2287

Practice Tips

- Special purpose provisions will often include a requirement that the Borrower remain solvent, and a breach of the special purpose provisions is typically a bad act that triggers personal liability for the Borrower and the Guarantor.
- However, a bad acts trigger for the Borrower's insolvency could in effect convert the Bad Acts Guaranty into a payment guaranty, because the Guarantor would be liable for the Borrower's unpaid debt if the collateral is not performing. This would effectively convert a non-recourse loan into a full recourse loan.
- To ensure that breach of the solvency covenant does not convert a non-recourse loan into a full recourse loan due to non-performing collateral:
  - Breach of the special purpose provisions should be an "above the line" trigger that makes the Borrower and Guarantor personally liable for the Lender's costs and expenses, as opposed to the full amount of the Loan.
  - The special purpose provision relating to the Borrower's solvency could apply only to the extent that there is sufficient cash flow from the collateral.