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IRS Agrees Traditional Bad Boy Guarantees Do Not Change Character of Nonrecourse Loan

The Internal Revenue Service has apparently seen the light — at least with respect to the effect of “bad boy” guarantees on a loan that is otherwise nonrecourse for income tax purposes. Last month, we reported that the IRS had issued an Internal Litigation Memorandum that took the position that a guaranty of repayment in the event the borrower makes an assignment for the benefit of creditors or admits that it is insolvent or unable to pay debts as they become due causes the loan to be treated as recourse debt, with the effect that the liability is allocable only to the guarantors. A new Generic Legal Advice Memorandum (GLAM) now concludes that this kind of a guaranty does not affect the character of the loan.

The new GLAM considers the same nonrecourse carve-out provisions discussed in the prior memorandum:

1. The borrower fails to obtain the lender’s consent before obtaining subordinate financing or transferring the secured property.
2. The borrower files a voluntary bankruptcy petition.
3. Any person in control of the borrower files an involuntary bankruptcy petition against the borrower.
4. Any person in control of the borrower solicits other creditors to file an involuntary bankruptcy petition against the borrower.
5. The borrower consents to or otherwise acquiesces or joins in an involuntary bankruptcy or insolvency proceeding.
6. Any person in control of the borrower consents to the appointment of a receiver or custodian of assets.
7. The borrower makes an assignment for the benefit of creditors, or admits in writing or in any legal proceeding that it is insolvent or unable to pay its debts as they come due.

The IRS recognized that these nonrecourse carve-outs are a fairly common practice in the commercial real estate finance industry and have been for many years. Lenders use these provisions to protect themselves from the risk that the borrower or guarantor in charge of the borrower will undertake “bad acts” that will diminish or impair the value of the property securing the loan, that might disrupt the cash flow from the property, or that could delay, complicate or prevent the lender’s repossession of the property in the event of a default. The IRS recognized that because these bad acts are all within the control of the borrower or guarantor, and it is in their economic self-interest to avoid committing these bad acts, they are very unlikely to occur. Accordingly, the guarantee should not affect

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the character of the liability as being nonrecourse, for either tax basis or at-risk purposes. However, if the bad act occurs, the guarantor will be treated as personally liable for the repayment of the loan. If you have any questions, please contact [Alan J. Tarr](#) (212.407.4900, atarr@loeb.com) or [Tom Lawson](#) (310.282.2289, tlawson@loeb.com).

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