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The Enforcement of Non-Recourse Carveouts in CMBS Loans: A Recent History

GARY A. GOODMAN AND SABRINA J. KHABIE

The authors of this article review two Michigan cases in which the plaintiff lender commenced litigation against the defendant borrowers and guarantors seeking the deficiency between the balance owed on the respective loan and the value of the secured property. The courts found for the plaintiffs and held the borrowers and/or the guarantors personally liable for the full amount of the unpaid deficiency. Expert reactions to the decisions are presented, as well as a review of recent state legislative action in this area.

One of the hallmark elements of a commercial mortgage-backed securities ("CMBS") loan is the isolation of the asset to be financed. The main indicia of asset isolation are separateness covenants, which assure a lender that the financed asset and the cash flows therefrom will be isolated from all other endeavors. These types of structures provide comfort to lenders making non-recourse loans, in which lenders agree to look solely to the mortgaged real estate to collect their debts. These loans, however, generally have carveouts

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backed by a guaranty which permits lenders to seek personal liability against the borrowers in the event of certain occurrences. The liability imposed upon the borrower and the guarantor may be limited to the actual losses incurred by the lender or may extend to the full amount of the indebtedness. Generally speaking, liability for the entire indebtedness is reserved for the most egregious acts within the borrower's control, such as violations of the prohibited transfer provisions or the filing of voluntary bankruptcy.[1]

The specific carveouts triggering personal liability for losses vary from deal to deal but most transactions include recourse events dealing with single-purpose entities, bankruptcy remoteness, breach of the due-on-transfer or due-on-encumbrance provisions of the loan documents and other "bad boy" acts.[2]

The concept of carve-out liability has been developed to protect non-recourse lenders against conduct by certain parties that may impair their ability to realize upon their collateral following a default. In the past, neither the guarantors nor the lenders expected these guaranties to be enforced.[3] However, two recent Michigan cases have demonstrated that such guaranties should not be ignored or underestimated.

In each of these two cases, discussed below, the plaintiff lender commenced litigation against the defendant borrowers and guarantors seeking the deficiency between the balance owed on the respective loan and the value of the secured property. The courts found for the plaintiffs and held the borrowers and/or the guarantors personally liable for the full amount of the unpaid deficiency.

51382 GRATIOT AVENUE HOLDINGS, LLC v. CHESTERFIELD DEVELOPMENT COMPANY, LLC AND *JOHN DAMICO v. MORGAN STANLEY MORTGAGE CAPITAL HOLDINGS, LLC* ("*CHESTERFIELD*")[4]

In this 2011 case, the loan agreement at issue was non-recourse but contained a springing recourse obligation that required the borrower to abide by certain provisions of Section 4.2(j) of the mortgage, which included the duty to remain solvent and to pay its debts from its assets as they become due.[5] When the plaintiff, as successor-in-interest to the loan originator, brought an action to collect the deficiency, the defendants, which consisted of the borrower and the guarantor, contended that they could not incur recourse liability solely due to non-payment of the loan as a result of deteriorating market conditions rendering the borrower insolvent or otherwise unable to pay its debts as they become due.[6] The court disagreed.

Absent ambiguity in the language of a contract, a court may not consider extrinsic evidence of the parties' intent to vary the meaning of such contract.[7] Furthermore, the parties' disagreement regarding the meaning of contract language does not, by itself, create an ambiguity.[8] Words are construed according to their plain and ordinary meaning unless it is clear a term is a legal term of art having a peculiar meaning.[9] The court in *Chesterfield* held that the relevant terms of the section — including the terms "insolvent," "debt," and "liabilities" — have clearly defined meanings that, when applied to the borrower's non-payment of the loan, indicate a violation of that provision.[10] The borrower unconditionally promised to pay the principal sum of $17,000,000 with interest in accordance with the terms of the note.[11] Consequently, the borrower had a "debt" or "liability" that became due on the first day of each month. When the borrower stopped making these payments, the terms of the loan agreement were violated. Moreover, the plaintiff argued that the borrower violated the obligation to remain solvent as a result of its default due to non-payment. When the plaintiff exercised its option to accelerate the loan, the borrower's mortgage debt was equivalent to the entire balance due on the loan, which far outweighed its assets. Thus, the defendant had become insolvent in viola-

tion of the loan agreement.

The failure to pay clause required the borrower to pay its debt and liabilities from "its assets."[12] Defendants argued that once the lender foreclosed, it had no assets and thus, had no duty to pay.[13] The court rejected this argument, holding that the mortgage required the borrower to pay its debts both "from its assets" and "as they became due."[14] To hold otherwise would essentially write out one of those phrases from the contract.[15]

Liability for the entire indebtedness of a loan is usually reserved for the most egregious acts. Thus, the defendants asserted that the interpretation of Section 4.2 of the mortgage was overly broad in that it caused the carveouts to swallow the non-recourse rule, essentially rendering the non-recourse component meaningless.[16] Defendants argued that the reading of this section produces "extremely absurd," "ridiculous," and "draconian" results when compared with the partial recourse carveouts contained in the note, which include losses due to fraud or intentional misrepresentation, or gross negligence or willful misconduct.[17] Essentially, the defendants argued that because the note contemplated only partial recourse liability in connection with egregious misconduct, the parties could not have intended the more onerous obligation of full recourse liability for non-payment of the loan, an event over which borrower or guarantor have little, if any, control. The court rejected this argument and held that the partial recourse carveouts allow lender to hold borrower personally accountable for any losses resulting from the enumerated misconduct, regardless of whether the loan agreement is in default and without offsetting those losses against the value of the property whereas full recourse liability comes into play only when the borrower defaults on the loan and the amount recovered through the lender's foreclosure is insufficient to satisfy the balance of the loan.[18] Regardless, however, the court held that the designation of the events as full recourse or partial recourse is unambiguous and "a court may not revise or void the unambiguous language of the agreement to achieve a result that it views as fairer or more reasonable."[19] The court held the borrower "had an obligation to repay the Loan in full, not an obligation to make payments on the Loan until doing so became financially undesirable or unfeasible and then await a foreclosure action."[20]

The court also rejected the defendants' argument that they did not violate Section 4.2 of the mortgage because the failure to pay prong in such Section refers to "debts and liabilities" in the plural, and the borrower only failed to pay a single debt.[21] In common practice, the court held, use of the plural means that the borrower's obligation to pay encompasses all of its debts and liabilities, such that failure to pay one such debt or liability means that it is not paying its "debts and liabilities" as required.[22]

Defendants offered extrinsic evidence, including the loan application, the commitment letter and an affidavit from the mortgage broker and guarantor, in an attempt to establish a latent ambiguity in the loan agreement. Defendants contended that such evidence shows that neither the borrower nor Morgan Stanley, the original lender, intended that the non-payment of the loan would result in full recourse liability. The court held, however, that the extent of the defendants' personal liability under the loan agreement is not a collateral matter that could give rise to a latent ambiguity; rather, it is a function of the contract terms.[23] Since the terms unambiguously provide that a failure to make loan payments nullifies the non-recourse provisions, extrinsic evidence cannot be used to vary unambiguous language in the agreement.[24]

The defendants used the same evidence to support their counterclaims that Morgan Stanley fraudulently misrepresented the nature of the loan and that a mutual mistake occurred with respect to the springing recourse event tied to non-payment of the mortgage.[25] After the court concluded that there was insufficient evidence to show fraud on the part of Morgan Stanley, the court then held that, at most, the evidence shows that both parties misunderstood the legal effect of the terms contained in the loan agreement.[26] When parties make mistakes regarding the legal effect of the contract actually made, that contract will seldom, if ever, be reformed unless there are other equitable legal features calling for the imposition of the court.[27] In this case, the court held that there were no equitable considerations that urged the court to relieve defendants of their obligations as the defendants were sophisticated parties who had the benefit of counsel when executing the loan agreement.[28]

The defendants claimed that the court's decision will have disastrous effects in the real estate market but the court disagreed.[29] While the court's

ruling in this particular case results in personal liability for a mortgage default, which is typically not permitted, the court believed that it was simply engaging in its duty to give effect to discrete agreements executed by individual parties.[30] The court emphasized that it is not obligated to enforce best business practices; rather, the court felt compelled to hold the individual parties to their bargain.[31] The parties were bound by the terms of the loan agreement they actually signed.[32] The borrower was free to negotiate terms favorable to its interest but it cannot later void the agreement when that decision produces unfavorable results.[33] A borrower's buyer's remorse is not cause for violating a contract.[34]

WELLS FARGO BANK, NA v. CHERRYLAND MALL LIMITED PARTNERSHIP AND DAVID SCHOSTAK ("*CHERRYLAND*")[35]

In this Michigan Court of Appeals case, the defendants appealed the trial court's ruling that the guarantor of the debt was liable for the loan deficiency since the borrower failed to remain solvent in violation of the single purpose entity ("SPE") covenants in the mortgage.[36] The defendants argued that only some of the covenants pertained to SPE status.[37] The court of appeals affirmed the trial court's ruling and granted plaintiff's motion for summary judgment.[38]

While a foreclosure generally extinguishes a mortgage, the trial court held that the instant mortgage provided for indemnification for losses based on the borrower's failure to comply with the terms of the mortgage and such indemnification survived any foreclosure.[39] The court held that the plaintiff was able to maintain its suit for a deficiency judgment based on the terms of the note, which stated that the debt was to be fully recourse to the borrower in the event that the borrower failed to maintain its status as a single purpose entity as required by the mortgage.[40]

There was no dispute that the loan documents provided for full recourse in the event the borrower failed to maintain its status as a single purpose entity; rather, the parties disagreed about what the borrower was required to do in order to maintain that status.[41] The court interpreted the terms of the mortgage because the note and guaranty expressly incorporated its provisions. Section 9(f) of the mortgage was introduced

by the heading of "Single Purpose Entity/Separateness" but none of its subsections ever used the words "single purpose entity" or identified which provisions were SPE covenants versus which were separateness covenants. The mortgage included a provision that borrower must remain solvent and must pay its debts and liabilities as they become due.[42] The defendants argued that this was an element of the separateness covenants, not the SPE covenants; the court disagreed and held that the mortgage unambiguously required the borrower to remain solvent in order to maintain its SPE status.[43] Having become insolvent, the borrower violated the SPE requirements which resulted in the loan becoming full recourse and the guarantor becoming fully liable for the deficiency.

The court looked to the decisions of three recent cases to support its holding. In *LaSalle Bank N.A. v. Mobile Hotel Properties.,* the mortgage at issue provided that the debt would become fully recourse in the event borrower failed to maintain its status as a single purpose entity in accordance with the mortgage, which included a list of fourteen separate covenants.[44] The list of covenants was almost identical to the list in Section 9 of the mortgage in the *Cherryland* case.[45] In *LaSalle Bank*, the court concluded that all fourteen items in the mortgage were requirements that, if violated, resulted in full recourse liability so it was irrelevant that a different covenant was at issue in that case.[46] In *Blue Hills Office Park LLC v. JPMorgan Chase Bank*, the guaranty at issue became full recourse in the event the borrower failed to maintain its status as an SPE in accordance with the mortgage, which included a covenant to remain solvent.[47] When the borrower transferred part of the mortgaged property without the lender's consent, the borrower breached the SPE covenants and became liable for the deficiency.[48] In both *LaSalle Bank* and *Blue Hills*, as in the *Cherryland* case, the mortgage contained a section entitled "Single Purpose Entity/Separateness" which contained multiple covenants required to maintain the entities' SPE status, including a covenant to remain solvent. Although different covenants were violated by the borrower in those cases, the court's holding was the same: the borrower failed to maintain its status as a single purpose entity and, as a result, violated the provisions of the non-recourse requirements. In W*ells Fargo Bank Minnesota, NA v. Leisure Village Assoc*., the borrower was

alleged to have violated a different subsection, but defendants made the same arguments as those made in *Cherryland*, namely that only some of the covenants pertain to single purpose entity status.[49] The trial court in that case dealt with, and rejected, all of the arguments made by the defendants in *Cherryland*.[50] The court gathered that all three of the recent cases made clear that maintaining solvency is always one of the covenants required to maintain SPE status.[51]

The guarantor argued that the solvency covenant had nothing to do with borrower's SPE status and there was no authority for the proposition that insolvency is a violation of SPE status.[52] While the court agreed that there was no precedent for this result, it held that all of the elements of Section 9(f) of the mortgage were elements of the borrower maintaining its status as an SPE.[53] The requirement to remain solvent was included in the SPE/separateness covenants of the mortgage.[54] Since the borrower violated these covenants, the non-recourse provisions were no longer applicable.

Defendants argued that Section 9(f) was not breached because the borrower's insolvency was not based on its own actions, but the downward spiral of the market.[55] However, the court held that Section 9(f) does not require insolvency to occur in any specific matter; rather, any failure to remain solvent is a violation.[56] Furthermore, the mortgage does not have a scienter requirement.[57]

Defendants also contended that should the court affirm the trial court's ruling, the result would be economic disaster for the business community.[58] The court, however, disagreed and held that the documents at issue were fairly standardized nationwide and defendants elected to take that risk.[59] As in the *Chesterfield* case, the court overtly expressed that it was not its job to enforce the best business practices: "It is not the job of this Court to save litigants from their bad bargains or their failure to read and understand the terms of a contract."[60] Furthermore, the court stated that it is not the judiciary's responsibility to address matters of public policy; this duty belongs to the legislature.[61]

The authors have been advised that, in light of the Michigan Nonrecourse Mortgage Loan Act discussed below, the defendants have appealed this decision to the Michigan Supreme Court.

EXPERT REACTIONS

Cherryland and *Chesterfield* stand for the proposition that solvency is always a requirement of an SPE, which triggers full recourse for borrowers and guarantors under the standard loan documents. While the recent cases seemingly hand victories to lenders, some experts question the decisions and the impact they will have on the CMBS market. Professor Dan Schechter disagrees with the court's decision in *Cherryland* because the only "bad act" was the borrower's default which was attributed to circumstances beyond its control.[62] He argues that the non-recourse obligation is virtually useless because the loan is only non-recourse until a default occurs. He goes on to argue that the entire contract may be void for lack of consideration because the lender's promise to refrain from seeking personal liability only exists for so long as the borrower makes timely payments. The loss of non-recourse protection due to the mere fact of default is nonsensical, especially when the default is in no way voluntary. He even goes so far as to predict reversal by the Michigan Supreme Court.

Professor Marshall Tracht insists the court in *Chesterfield* was wrong in its refusal to reform the loan agreement.[63] If the parties intended something other than what was written in the loan agreement, this might be a cause for reformation of the contract; however, the court erroneously declined to engage in such reformation.[64] This was erroneous since the Michigan Supreme Court has said, "if reading a written instrument (which both parties thereto admit did not express their intention) precludes reformation thereof on the ground of mutual mistake, then we wipe out hundreds of years of equity and elevate the scrivener to the ermine. The chancellor will amend an instrument to represent the actual agreement of the parties regardless of the content on the parchment."[65] While the court held that there must be some other equitable feature calling for the interposition of the court, this should apply only when the mistake is to the legal effect of the contract, not when the writing fails to actually reflect the contract made, which is the case in *Chesterfield*.[66] The mistake is about the drafting of a term that failed to reflect the actual intent of the parties as to the basic economic allocation of risks and rewards in the transaction.[67] Professor Tracht argues that such a mistake must be corrected if contract law is to accomplish its basic function of carrying out the mutual intent of the parties.[68]

With regards to the *Cherryland* case, Professor Tracht believes that the court erroneously failed to analyze the differences between SPE covenants and separateness covenants while holding that the covenants in Section 9 of the mortgage were elements of the borrower maintaining its status as an SPE.[69] He believes that anyone familiar with non-recourse real estate lending knows that the court's conclusion that any failure to remain solvent was a violation was not the business deal the parties intended.[70]

There are concerns that the result of these cases will be disastrous for the commercial real estate industry should these decisions survive appeal and should courts in other jurisdictions follow suit. Some of the potential effects include: violations of these provisions nullify the non-recourse provisions and are events of default in and of themselves, which will cause every SPE with this form of covenant whose property is worth less than the outstanding non-recourse debt to be in default.[71] This will undoubtedly affect property owners and guarantors but the risks also run to innocent tenants whose leases may be extinguished by a foreclosure.[72] Furthermore, since many guarantors sign far more contingent guaranties than they could ever repay, it would only take a small number of judgments against such guarantors to render them technically insolvent and subject them to liens and levies, which in turn will trigger defaults on their other loan agreements.[73] Some aggressive loan buyers may even take advantage of these holdings by buying debt and suing guarantors.[74] These decisions may also dilute the disincentives to file bankruptcy if guarantors believe they will be liable for the debt no matter what.[75]

Additionally, these guaranties will not be springing at all; they will be unconditional guaranties without any deterrent effect.[76] If the guarantor will be liable whether or not the SPE files bankruptcy, what does the SPE have to lose in filing? Since it is no skin off the SPE's proverbial back, this can lead to many bankruptcy filings. Another potential result of these guaranties being enforced is that many parties who signed these guaranties will find themselves in financial straits which will disrupt their operations and render them unable to make necessary investments in their properties which, in turn, will have a detrimental effect on lenders.[77]

LEGISLATION

On March 7, 2012, the Michigan Senate passed a bill "overturning" the result of these two decisions, on March 20, 2012, the Michigan assembly passed it and on March 29, 2012, the governor of Michigan signed the Nonrecourse Mortgage Loan Act into law. It remains to be seen whether this legislation will withstand constitutional scrutiny as an attempt to retroactively modify existing contracts. The authors have been advised that such challenges have already been commenced. So far, no other state seems to have proceeded down this path legislatively.

Notwithstanding the foregoing, any well-represented borrower is generally successful during loan document negotiations in obtaining lender's consent to modification of the relevant SPE covenant to condition the same upon there being sufficient cash flow from the mortgaged property. The future players of CMBS will take these decisions into consideration and draft around both decisions.

CONCLUSION

These cases should serve as a wake-up call with respect to the negotiation and drafting of non-recourse provisions to reflect the parties' exact intentions and expectations.[78] In rendering their decisions, one factor the courts heavily considered is the parties involved in the transaction. In *Chesterfield*, the court refused to reform the loan agreement because the parties were sophisticated and had the benefit of counsel. While attorneys have an ongoing duty to zealously represent their clients' needs, these holdings will put even more pressure on them to negotiate terms that are fair and reasonable.

Another factor that weighs heavily on the courts' decision is the language in the documents. The holdings of both cases resulted from the courts' strict construction of the language in the carveout provisions.[79] The courts will hold parties to the words that are contained in the relevant documents because, the courts assume, the attorneys put them there for a reason. The courts will not allow extrinsic evidence to be brought in to show what the parties intended to say in the agreements. Even if both

parties intended that there be no personal liability, their actual intent will not control over the unambiguous words of the documents.[80] A contrary intention is no longer a fallback argument to avoid recourse obligations imposed on a borrower or guarantor. Thus, there is now even more pressure on the parties to say what they mean and mean what they say.

Attorneys and borrowers alike should heed the warning arising out of *Chesterfield* and *Cherryland*. These cases demonstrate that when solvency is a requirement of a borrower in order for a loan to remain non-recourse, a court will not consider what circumstances led to an insolvency; it is only concerned with the fact that an insolvency actually occurred. These holdings are especially poignant in these economic times, where property values are rapidly declining through no fault of the property owners.

When it comes to interpreting and enforcing loan documents, the courts are clear on one thing: it is not their job to enforce the best business practices or to save borrowers from bad bargains. While we expect the courts to solve disputes with fair and equitable results, we cannot rely on them to save parties from poor drafting. Ultimately, the borrowers, and in turn their attorneys, are responsible for their own well-being.

NOTES

[1] John R. Rutledge and David L. Weintraub, *When is Nonrecourse Loan Fully Recourse?,* Law 360, March 9, 2012, http://www.law360.com/articles/316250.

[2] Marshall Tracht, *Godzilla Lives! Or, Nonrecourse Carveouts Run Amok*, Pratt's Journal of Bankruptcy Law (April 2012) ("Tracht").

[3] *Id*.

[4] 2011 WL 6153023 (E.D. Mich. 2011).

[5] *Chesterfield*, 2011 WL 6153023, at *7.

[6] *Id.*

[7] *Id.* at *8.

[8] *Id.*; *Burkhardt v. Bailey,* 680 N.W.2d 453, 464 (Mich. Ct. App. 2004).

[9] *Chesterfield,* 2011 WL 6153023, at *8.

[10] *Id*.

[11] *Id.* at *9.

[12] *Id*. at *7.
[13] *Id.* at *13.
[14] *Id*.
[15] *Id*.
[16] *Id*.
[17] *Id.* at *11.
[18] *Id*.
[19] *Id*.
[20] *Id*. at *13.
[21] *Id.* at *14.
[22] *Id*.
[23] *Id*.
[24] *Id.*
[25] *Id.* at *17.
[26] *Id.* at *18.
[27] *Id.* at *18; *Johnson Family Ltd. P'ship v. White Pine Wireless, LLC*, 281 Mich.App. 364, 761 N.W.2d 353, 363 (2008).
[28] *Chesterfield* WL 6153023 at *18.
[29] *Id.* at *15.
[30] *Id*.
[31] *Id.*
[32] *Id.* at *16.
[33] *Id.*
[34] *Id.*
[35] 2011 Mich. App. LEXIS 2360 (Mich. Ct. App. Dec. 27, 2011).
[36] *Cherryland,* 2011 Mich. App. LEXIS 2360, at *10.
[37] *Id.* at *9.
[38] *Id.* at *1.
[39] *Id.* at *11-12.
[40] *Id.* at *13.
[41] *Id.* at *15.
[42] *Id.* at *18.
[43] *Id.* at *21.
[44] *LaSalle Bank NA v. Mobile Hotel Props, LLC,* 367 F. Supp. 2d 1022, 1029 (E.D. La., 2004).
[45] *Id.; Cherryland,* 2011 Mich. App. LEXIS 2360, at *31.
[46] *Id.* at *31-32.

[47] *Blue Hills Office Park LLC v. JPMorgan Chase Bank*, 477 F. Supp. 2d 366, 383 (D. Mass., 2007).
[48] *Id.*
[49] Transcript of Hearing, *Wells Fargo Bank Minnesota, NA v. Leisure Village Assoc.,* No. 00-031860-CZ (Mich. Cir. Ct. 2001).
[50] *Cherryland,* 2011 Mich. App. LEXIS 2360 at *36.
[51] *Id.* at *37.
[52] *Id.* at *29.
[53] *Id.* at *37.
[54] *Id.* at *28.
[55] *Id.* at *38.
[56] *Id.*
[57] *Id.*
[58] *Id.* at *38.
[59] *Id.* at *39.
[60] *Id.*
[61] *Id.* at *40.
[62] *Borrower's Default and Insolvency Constitute Violations of "Separateness" Covenants, Thus Triggering Recourse Provisions in Note and Guarantee,* Com. Fin. Newsl., Jan. 9, 2012, at 2.
[63] *See* Tracht, *supra* note 2.
[64] *Id.*
[65] *Johnson Family Ltd. P'ship v. White Pine Wireless, LLC*, 761 N.W.2d 353, 372-373 (Mich. Ct. App. 2009) (quoting *Urick v. Burge*, 350 Mich. 165, 86 N.W. 543 (1957)).
[66] Tracht
[67] *Id.*
[68] *Id.*
[69] *Id.*
[70] *Id.*
[71] *Id.*
[72] *Id.*
[73] *Id.*
[74] David R. Kuney, Sidley Austin, LLP, Springing Guaranties: Does Recourse "Spring" for Failure to Pay the Mortgage or Insolvency? (Mar. 7, 2012).
[75] *Id.*
[76] Tracht

[77] *Id.*

[78] John Murray, Enforceability of Carveouts to Nonrecourse Loan: Recent Cases, American College of Real Estate Lawyers Newsletter (forthcoming 2012) (manuscript at 7).

[79] *Id.*

[80] Tracht