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Are carve-outs to nonrecourse loans only for the 'bad boys'?

Many commercial loans that are secured by real property are nonrecourse to the borrower and the borrower-related guarantors. In such deals, the lender agrees that if an event of default occurs, the lender may exercise remedies against the real property and any other collateral given by the borrower securing the borrower's obligations under the loan, but cannot enforce a deficiency judgment against the borrower or guarantors or sue on the note. This is almost always the case for commercial mortgage-backed security loans, which also usually require the borrower to be a single-asset, bankruptcy-remote entity, more commonly known as a special-purpose entity. The restriction on enforcement actions against the collateral only is subject to a litany of exceptions, some of which trigger recourse liability against the borrower and guarantors for the amount of the loss suffered by the lender, while others trigger full recourse liability against the borrower and guarantors for the entire loan amount and any other obligations to the lender. These exceptions often are referred to as "bad boy" carve-outs because the triggers for recourse liability are thought to be limited to bad acts of the borrower and guarantors. However, the actual language in the loan documents for these carve-outs may well be much broader.

The triggers for partial or full recourse liability of the borrower and guarantor usually include such bad acts as material misstatements of fact; fraud; misappropriation or misapplication

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of insurance proceeds, condemnation awards, trust funds, rents or security deposits; breach of representations, warranties or covenants pertaining to environmental matters; failure to pay real estate taxes or insurance premiums; material physical or economic waste of the secured property; voluntary bankruptcy by the borrower; and consent to or acquiescence by the borrower in an involuntary bankruptcy of the borrower. However, another common trigger for recourse liability is a violation of some or all of the borrower's SPE covenants. The SPE covenants that trigger recourse liability when violated may be as narrow as a limitation on the borrower's sole purpose as owning, operating and leasing the secured property and engaging in related activities. Or, the SPE covenants included in the recourse triggers may encompass a long list of separateness covenants, such as maintaining separate books, records, financial statements and bank accounts; conducting business in the borrower's own name; using separate stationery, invoices and checks bearing the borrower's own name; not commingling the borrower's assets with those of anyone else; maintaining adequate capital; and remaining solvent.

Unless the loan documents provide otherwise, once a listed trigger event occurs, the borrower and guarantors may be personally liable for the lender's losses or the entire debt regardless of whether the triggering act is later cured or if the lender is not directly harmed by the act. Even a technical default or "foot fault" by the borrower could irrevocably convert a nonrecourse loan to partial or full recourse debt if it falls within the recourse triggers. There have been several recent cases in which lenders have successfully enforced these provisions against borrowers and guarantors in which the courts have dismissed arguments such as imposing recourse liability is contrary to the parties' intent and the lender suffered no direct loss as a result of the trigger at issue. On the contrary to such arguments, courts have been willing to impose recourse liability against the borrowers and guarantors when the language of the loan documents expressly permits it on the grounds that the lenders deserve the benefit of their contractual bargains.

The most talked about case in the legal community in recent months that addresses nonrecourse carve-outs is the Cherryland case, which was decided by Michigan's Court of Appeals *(Wells Fargo Bank NA v. Cherryland Mall Limited Partnership, et al., Dec. 27, 2011)*. In *Cherryland,* after the lender foreclosed on the secured property, it sought to recover more than $2 million on a mortgage deficiency claim against the borrower and individual guarantor. The lender asserted that the loan became full recourse against the borrower and guarantor upon the occurrence of the trigger event that the borrower failed to maintain its SPE status when it became insolvent. Among other things, the borrower and guarantor argued that the mortgage did not clearly spell out which SPE covenants were covered by the trigger and an interpretation that the borrower's insolvency converted the loan from nonrecourse to recourse was against both the character of a nonrecourse deal and public policy. Nevertheless, the court held that the loan became full recourse upon the borrower's insolvency as expressly provided in the loan documents. This decision shocked the commercial real estate community because it called into question whether billions of dollars in CMBS loans (and other nonrecourse loans with similar recourse triggers and SPE provisions) would become recourse merely upon a borrower's inability to pay its loan. After an immediate national backlash against the court's decision, the Michigan Legislature passed a law prohibiting a solvency covenant from triggering full recourse of a nonrecourse loan, effectively overturning the *Cherryland* decision in Michigan.

Borrowers and guarantors should always carefully read the nonrecourse carve-outs and ensure that they understand the scope of the prohibited actions and who is in a position to cause or prevent them. Of course, it is too late to negotiate these provisions once a loan is closed. But, when possible, borrowers and guarantors should be careful to consider the consequences of taking or omitting to take any action that may trigger recourse liability.▲