Commercial Real Estate Loans: Trends in Carveout Guaranties

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This Practice Note discusses nonrecourse guaranties and their role in commercial real estate lending. It analyzes developments in nonrecourse carveout guaranties over time and some of the surprising recent court decisions that interpret and apply nonrecourse carveout provisions.

WHAT ARE CARVEOUT GUARANTIES?

Commercial real estate borrowers and lenders typically structure their financing transactions as nonrecourse loans. Any loan of this type limits the lender's recourse to the collateral securing the loan, primarily the borrower's real estate.

Fundamentally, in a nonrecourse loan, the lender – not the borrower – bears the risk that the property may decline in value, below an amount sufficient to repay the loan, as a result of market fluctuations or other circumstances beyond the borrower’s control. Likewise, if the property’s cash flow will not pay debt service, no one has an obligation to cover the shortfall; it is the lender’s problem and the lender’s solution will be to foreclose.

Lenders do, however, demand protection against two potential perils to their collateral: first, "bad acts" that a borrower might commit, to the detriment of the lender's position; and second, some external risks such as environmental problems. Lenders typically want to "carve out" these perils from the general nonrecourse nature of the loan. To protect themselves against these perils, lenders typically demand and receive nonrecourse carveout guaranties, sometimes called bad boy guaranties. The borrower's ultimate owners – whether individuals or entities – often serve as guarantors.

A carveout guaranty usually allows a lender to seek recovery against the guarantor for whatever losses the lender suffers from particular problems the guaranty covers. For example, if the borrower diverts security deposits, the guarantor would face liability for the loss the lender suffered because of the diverted security deposits. This Note refers to that type of guarantor exposure (or lender recovery) as "loss liability."

In extreme cases, if something really bad happens, the guaranty may require the guarantor to pay the entire loan. This Note refers to that type of guarantor exposure (or lender recovery) as "full loan liability." It tends to arise only for particularly egregious acts by the borrower, often where it would be difficult for the lender to establish the exact magnitude of the lender’s loss. Full loan liability exists, for the most part, to give the borrower/guarantor an incentive to behave.

If a lender obtains a judgment against a guarantor based on either measure of liability, that is, loss liability or full loan liability, the lender can enforce that judgment against any assets of the guarantor, not just against the lender's collateral.

This Note discusses how carveout guaranties evolved and, more recently, mutated. This Note also discusses recent court decisions in this area and the courts' sometimes notable interpretations of nonrecourse carveout clauses in what generally looked like "industry standard" nonrecourse loan documents.

For more suggestions on strategies to negotiate nonrecourse carveout guaranties, see the author's *Practice Note, Commercial Real Estate Loans: Negotiating Carveout Guaranties (http://us.practicallaw.com/2-521-0515)* and *Standard Clauses, Commercial Real Estate Loans: Nonrecourse Carveout Provisions (http://us.practicallaw.com/8-520-8519)*.

WHY NONRECOURSE LOANS MAKE SENSE FOR COMMERCIAL REAL ESTATE

LENDER'S PERSPECTIVE

A typical commercial real estate lender decides to fund a loan only after determining that the collateral can support the contemplated financing, usually with room to spare.

In a nonrecourse mortgage loan, the lender accepts the risk that the borrower might default, which is the borrower's option and right. If that happens, the lender can foreclose and take or sell the collateral. That is the risk and the very strong remedy that the lender owns. Nonrecourse loans contemplate that the lender relies on the foreclosure process (and other rights and remedies), and ultimately the right to take the collateral, rather than on anyone's credit, including the credit and personal assets of the borrower's ultimate principals.

Commercial real estate lenders accept the risks and benefits of nonrecourse financing for many reasons. They live without the comfort of a creditworthy borrower because they take comfort from their collateral, typically for these reasons:

- A lender estimates the value of the real property collateral and lends significantly less than full market value. This limit on the loan amount gives the lender a cushion against problems and surprises.
- A lender underwrites the mortgaged property to try to fully understand its characteristics and issues. The lender identifies and tries to mitigate property-related risks and ultimately gains comfort that the income of the collateral supports the debt service on the lender's loan and would also support the debt service on a hypothetical loan that the borrower could eventually obtain to refinance the current lender's loan.
- Loan documents require extensive reporting and monitoring, often with mechanisms so the lender can take greater practical control of the collateral if the lender sees trouble ahead.
- The right to foreclose gives the lender an extraordinarily powerful remedy: the ability to acquire or sell property whose value should significantly exceed the amount of the lender's entire loan (or at least did at the time of the closing). Lenders traditionally relied on that remedy as the main event if a borrower did not perform.

Finally, if a lender wants to stay competitive in the market for traditional long-term financing on stabilized real property, the lender needs to offer nonrecourse loans, because that is what the other lender down the street will offer.

BORROWER'S PERSPECTIVE

Commercial real estate borrowers demand nonrecourse loans for some of the reasons suggested above for lenders (see *Lender's Perspective*). For a borrower, though, the most fundamental reason to demand a nonrecourse loan relates to preserving the borrower's ability to "walk away" from the property should a borrower ever deem it necessary to do so. In such circumstances, nonrecourse financing means the borrower does not need to keep "feeding" an investment that has turned out badly. A borrower can limit its exposure, and give up the collateral to the lender.

Borrowers also demand nonrecourse loans because, under complex tax rules, these types of loans allow investors to fully deduct depreciation arising from their real property. Those rules say that if a loan is nonrecourse, then investors can claim their share of the debt as part of their investment in the collateral, something they possibly cannot do otherwise. That investment becomes the starting point for depreciation deductions. Unless investors can claim a substantial investment in the real estate for tax purposes, the investors may find themselves unable to take substantial depreciation deductions. Collectively, and not only to protect depreciation deductions, US tax law principles give real estate investors a major reason to want nonrecourse financing. Those tax law principles are complex and outside the scope of this Note.

In the world of securitized lending, nonrecourse loans help achieve marketability and successful execution. Nonrecourse loans are easier for rating agencies and bond buyers to understand and assess because they depend on real estate, which is considered relatively easier to underwrite, rather than on a guarantor's credit, which is harder to underwrite. If a guarantor signs only a carveout guaranty, the underwriting of that guarantor's credit does not assume central importance in the overall analysis that the securitization process requires.

For more information about securitized commercial real estate loans, see *Practice Note, Commercial Mortgage-backed Securities (CMBS) Finance: Overview (http://us.practicallaw.com/9-583-9145)*.

EVOLUTION OF NONRECOURSE CARVEOUT CLAUSES

Even before the real estate recession of the early 1990s, commercial real estate lenders knew that although nonrecourse loans generally made sense for real estate financing, lenders faced certain limited risks for which they wanted recourse beyond their collateral.

NONRECOURSE CARVEOUT GUARANTIES IN THE 1980S

A commercial real estate loan that closed in the 1980s may have included a general nonrecourse clause, followed by a short list of carveouts. A typical nonrecourse carveout clause from the 1980s might have looked like this:

> "Notwithstanding the foregoing nonrecourse provisions, Borrower shall be personally liable to Lender for any and all monetary losses imposed upon or incurred by or asserted against Lender and directly or indirectly arising out of or in connection with Borrower's: (i) obligations under the Section of the Mortgage captioned Environmental Matters; (ii) acts or omissions constituting fraud or misrepresentation in applying for the Loan or in supplying information or documents to Lender; (iii) misappropriation or misapplication of any insurance proceeds, condemnation awards, or security deposits; or (iv) waste."

This sample clause is brief and makes only the borrower, not any guarantor, personally responsible for the carveouts listed. If the borrower was a general partnership with an individual general partner (which sometimes still occurred in the 1980s), then the liability would have flowed through to that individual. Borrowers could and did prevent personal liability by using corporate general partners.

Although each nonrecourse carveout in the sample clause relates to a serious matter, each of the carveouts:

- Is straightforward and simple.
- Is readily comprehensible.
- Describes events within the borrower's control, except in the case of environmental risks.
- Limits the carveout liability to whatever loss the lender actually suffered from a particular bad event with no suggestion that anyone ever becomes personally liable for the entire loan.

REAL ESTATE DEPRESSION OF THE 1990S

The real estate depression of the early 1990s taught lenders that traditional nonrecourse clauses did not respond well to collapsing real estate values and aggressive borrowers. Lenders and borrowers learned that if a borrower wanted to fight, the borrower could drag out the loan enforcement process for years, culminating at some point in a bankruptcy filing, which would take another year or two. In that time, the borrower could "milk" the property by using rental income to pay for its fight with the lender rather than to cover maintenance, repairs, real estate taxes, insurance premiums, operating costs and debt service.

Although nonrecourse lenders would eventually still recover (or sell) their collateral in most cases, they had no claim against anything or anyone else beyond their impaired collateral. They had no meaningful source of compensation for the delay, deterioration, lost revenues and other problems they experienced through the drawn-out process of foreclosure, lender liability litigation and often a last-minute bankruptcy filing just before the foreclosure sale.

In response, when commercial real estate financing began its cyclical recovery in the middle of the 1990s, lenders started to revisit and rethink their nonrecourse clauses in light of lessons learned from the loan defaults of the early 1990s. As nonrecourse carveouts developed further in the mid-1990s, they:

- Went beyond making the borrower liable for the carveouts, but also started to require guaranties of the carveouts from the principals, because lenders recognized that if a borrower is a single purpose entity (SPE), then it lacks any meaningful assets to back carveout liability. The only assets the borrower has have already been mortgaged to the lender, so a carveout claim against the borrower gives the lender nothing the lender did not already have.
- Expanded from loss liability, where the guarantor faced personal liability only for the lender's actual losses suffered, and moved toward full loan liability, where the guarantor faced full liability for the entire loan if certain very bad events occurred.
- Expanded to cover a wide range of borrower acts and external risks, ranging from the serious to the trivial.

Ultimately, in response to the real estate depression of the early 1990s, carveout guaranties went far beyond the original intent and motivations for nonrecourse carveouts and the industry agenda that drove them.

A WIDER RANGE OF POTENTIAL MISFORTUNES

As part of that process, lenders tried to make guarantors liable for a wide range of misfortunes that might befall the transaction, most within the borrower's control. Lenders then identified a few of those potential misfortunes as being so egregious that if they ever occurred, the guarantor not only had to make the lender whole for any losses suffered (loss liability), but also faced full loan liability.

These full loan liability carveouts – originally intended to ensure that the borrower did not destroy the collateral or otherwise misbehave – eventually became a dire threat for guarantors. Over time, as the list of carveouts grew, it seemed a lender could offer a rationale to make almost every obligation in the loan documents a nonrecourse carveout. Most of these were loss liability carveouts, but some became full loan liability carveouts. To some degree, carveout liability eclipsed mortgage foreclosure as the lender's main remedy if bad things happened.

Loss Liability Carveouts

Depending on the negotiations, loan documents in the late 1990s started to include a long list of bad acts that could trigger loss liability carveouts. These bad acts included the borrower's failure to:

- Deliver books and records to the lender after foreclosure.
- Pay brokerage commissions, closing costs or commitment fees.
- Comply with laws, often with special attention to grand new legislative schemes, such as the Americans with Disabilities Act of 1990, which caused particular concern.
- Reimburse the lender for costs of successfully enforcing the loan after default, including any transfer taxes.
- Indemnify the lender as the loan documents required.
- Pay insurance premiums.
- Pay yield maintenance payments.
- Comply with restrictions on entering into, amending leases or accepting prepaid rent.
- Pay mechanics' liens.
- Apply rental income first to pay property expenses and debt service.
- Maintain security deposits in trust.
- Comply with loan prohibitions on removing personal property collateral.
- Repair (and sometimes even maintain) the property.
- Pay real estate taxes.
- Comply with leasing restrictions.
- Comply with the Employee Retirement Income Security Act of 1974 (ERISA).

Other new loss liability carveouts required the guarantor to make the lender whole if the borrower:

- Becomes subject to any forfeiture of the collateral under criminal forfeiture laws, even if the borrower had nothing to do with the forfeiture, such as because it arose from a tenant's illegal activities.
- Interferes with the lender's attempts to collect rent after default.
- Defends against the lender's enforcement proceeding (but perhaps only if the borrower's defenses failed or were frivolous).

Full Loan Liability Carveouts

Depending on the negotiations between the guarantor and lender, a guarantor sometimes assumed full loan liability for the entire loan in certain cases. Full loan liability could arise, for example, if the borrower:

- Conveys the property in violation of transfer restrictions in the loan documents.
- Obtains secondary financing in violation of the loan documents.
- Files voluntary bankruptcy (or, later, colludes with an involuntary bankruptcy filing).
- Defaults under a ground lease securing the loan.
- Claims a partnership between borrower and lender.
- Breaches covenants intended to assure the borrower remained an SPE and would not be consolidated into a hypothetical bankruptcy proceeding of the borrower's parent company.

Each full loan liability carveout arose from some risk (or issue) that could fundamentally alter either, or both, of the:

- Nature or existence of the lender's collateral.
- Risk profile of the transaction to the lender.

Often, the lender could not quantify the loss the lender would suffer if one of these acts or events occurred and hesitated to establish only a loss liability carveout. Instead, the lender made these risks full loan liability carveouts, in the belief and hope that this would motivate the carveout guarantor to use its control of the borrower to assure that none of these really bad events ever happened.

As commercial real estate finance moved from the "originate and hold" model to the "originate and sell" model, whether for securitization or just to another investor, loan originators sometimes felt that they needed to keep broadening their nonrecourse carveouts to help with their subsequent loan sales.

Borrowers and guarantors came to accept nonrecourse carveouts and their endless expansion and increasing complexity, because guarantors tended to assume they could readily avoid any exposure. They could, after all, easily assure that the borrowers they controlled did not do "bad things" or, in the case of full loan liability carveouts, "really bad things." Except for carveouts for external events that created a "hot button" risk for lenders such as environmental problems, everyone knew nonrecourse carveouts caught only "bad boys" in their net. The nonrecourse carveouts gave borrowers an incentive to be "good boys," but no one expected "good boys" to face liability under the carveouts.

SURPRISING DECISIONS IN RECENT CASES

Litigation growing out of the 2008 financial crisis recently showed the commercial real estate world that the ever-expanding intricacies of modern loan documents have unintentionally made nonrecourse carveouts so broad, and at the same time so intricate and convoluted, that a court can interpret them in a way very different from the deal theory, dynamics and overall intentions that originally drove nonrecourse financing.

Based on interpretations of these types, the carveouts can sometimes make the guarantor liable for the entire loan when no one ever would have expected such liability to arise. The commercial real estate finance industry has universally accepted the logic of nonrecourse financing as described above, and the recent cases completely contradict that logic.

In all the decided cases summarized in this Note, the loan documents looked like "typical" nonrecourse loan documents, where:

- The lender was supposed to own the risk of the borrower's insolvency (except voluntary or collusive involuntary bankruptcy) and property-related distress.
- The nonrecourse carveouts were intended only to prevent the borrower from doing bad things.

It did not turn out that way in some of the recent decisions (see *Unfavorable Cases for Guarantors*).

The underlying theory of nonrecourse financing assumes that lenders, and not borrowers, own the risk of adverse market conditions, reductions in cash flow, marketplace declines of real estate values and other real estate risks that might turn out to make the collateral less valuable than the parties hoped. Lenders mitigate that risk through the protective and conservative measures discussed earlier in this Note, including, above all, careful underwriting.

Marketplace participants generally believe that nonrecourse carveouts are intended only to prevent borrowers and guarantors who control them from doing bad things to the collateral or the lender. Carveouts are not supposed to give lenders all-purpose protection against ordinary marketplace declines and a variety of ordinary borrower defaults triggered by ordinary problems with the collateral.

More recently, lenders and opportunistic purchasers of defaulted loans have sometimes scoured the nonrecourse carveouts in the loan documents and found that they can stretch the language in ways that make guarantors personally liable for the entire loan under exactly the kinds of circumstances that market participants assumed and believed represented risks that lenders, not borrowers or guarantors, bore in any nonrecourse loan.

These recent cases should give any carveout guarantor cause for concern about, and guidance for how to avoid, unexpected and unintended liabilities under nonrecourse carveout guaranties. For a more extensive discussion of these and other recent cases on nonrecourse carveout guaranties, with an emphasis on the many cases that lenders have won, see John C. Murray & Randall L. Scott, *Enforceability of Carveouts to Nonrecourse Loans: An Evolution, 48 ABA Real Property, Trust and Estate Law Journal 1 (Fall 2013)*. The authors of this article regularly update it.

UNFAVORABLE CASES FOR GUARANTORS

Of the recent court decisions that have stunned guarantors and the real estate financing marketplace, including both borrowers and loan originators, the two most notable examples come from Michigan. Those cases, along with two from New Jersey and Indiana, produced surprising results for carveout guarantors. One can expect to see more cases like these, although we are also seeing a number of cases that have turned out favorably for guarantors.

In each of the four cases just mentioned, the specific words of the loan documents, sometimes as embodied in a complex structure of interacting defined terms and cross-references, produced a surprise for the guarantor in the form of unexpected full loan liability as a result of the borrower's financial problems. That happened even though a borrower's financial problems, on their own, were never intended or expected to trigger carveout liability for guarantors under the industry's typical expectations for how nonrecourse carveouts worked.

The Cherryland Case

In *Wells Fargo Bank, NA v. Cherryland Mall Ltd. Partnership*, the Michigan Court of Appeals held that the guarantor faced full loan liability as soon as the borrower became insolvent (*812 N.W.2d 799 (Mich. Ct. App. 2011)*). In this case, the borrower's insolvency arose largely from the burden of the very loan whose nonrecourse status should have protected the guarantor from full loan liability.

The *Cherryland* loan documents required the borrower to remain an SPE. The SPE covenants in the loan documents said that as part of remaining an SPE, the borrower needed to remain solvent. The loan documents provided for full loan liability for the guarantor if the borrower ever stopped complying with the SPE covenants.

When the distressed borrower defaulted on the loan, the court agreed with the first mortgagee plaintiff that the decline in property values made the borrower "insolvent," because the loan amount exceeded the value of the collateral. That, in turn, meant that the borrower did not maintain its SPE status as the loan documents required, which triggered a full loan liability carveout under the guaranty. In essence, the loan became full recourse because of declining property values, even though nonrecourse loans put the risk of any such decline on the lender, not the borrower or the guarantor.

The Chesterfield Case

In *51382 Gratiot Avenue Holdings, LLC v. Chesterfield Development Co., LLC*, the lender asserted full loan liability against the guarantor on a theory not too different from the *Cherryland* case (*2:11-CV-12047, 2012 WL 205843 (E.D. Mich. Jan. 24, 2012)*).

The *Chesterfield* loan documents contained separateness covenants that required the borrower not to "become insolvent or fail to pay its debts and liabilities from its assets as the same shall become due." The court agreed with the lender that the borrower became insolvent when its debts – again including the nonrecourse mortgage loan – exceeded the value of its assets. Thus the borrower violated the separateness covenants, and any violation of the separateness covenants triggered full loan liability.

The guarantor argued that the borrower's nonrecourse obligation to pay the loan by definition could not exceed the value of the collateral and by surrendering the collateral to the lender the borrower discharged the debt. The court disagreed, declaring that the borrower's nonrecourse payment obligation consisted of an obligation to pay the loan in full; the obligation was not limited to the value of the collateral. The court rejected the borrower's concept that, as the court described it, the borrower's obligation to pay the loan continued only until doing so became "financially undesirable or unfeasible" so the borrower could then simply "await a foreclosure action." That rejected view of nonrecourse financing conforms exactly to the commercial real estate industry's view of nonrecourse financing. Indeed, from a business perspective, it is the whole point of nonrecourse financing. But the court ignored it.

In the *Chesterfield* case, the one occasion when "nonrecourse" really matters became the occasion that triggered the guaranty – again, not at all what anyone has in mind for a typical nonrecourse loan.

The guarantor argued, among other things, that the lender's interpretation of the nonrecourse carveout trigger is contrary to public policy and "does violence to the very nature of commercial mortgage backed security loans … and the court's enforcement of those provisions as written will have disastrous consequences in the real estate market." The court did not care.

The Princeton Park Case

In *CSFB 2001-CP-4 Princeton Park Corporate Center, LLC v. SB Rental I, LLC*, the Superior Court of New Jersey Appellate Division enforced a full loan liability carveout against a guarantor when the borrower obtained a small second mortgage without obtaining the lender's prior written consent as the loan documents required (*980 A.2d 1 (N.J. Sup. Ct. App. Div. 2009)*). Although the borrower promptly paid off that second mortgage, the borrower forgot to have it released of record, and it eventually came to the lender's attention. The court agreed with the first mortgage lender that this sequence of events, even though fully cured and corrected, still constituted prohibited secondary financing, thus triggering the full loan liability carveout against the guarantor.

The Weinreb Case

In *Steven Weinreb v. Fannie Mae*, the Court of Appeals of Indiana allowed the lender to recover the full deficiency – including a massive prepayment premium – from a carveout guarantor based on the recording of some minor mechanics' liens (*993 N.E.2d 223 (2013)*).

Two years after Arbor Commercial Funding, LLC originated the loan, the borrower stopped paying. The borrower also failed to release four mechanic's liens against the property within the cure period allowed by the loan documents. The court determined that the mechanic's liens constituted an impermissible transfer under the loan documents, triggering full loan liability under the guaranty. Because the lender accelerated the loan relatively early in its term, the prepayment premium totaled 25% of the initial principal of the loan. The guarantor argued that he should not face personal liability because:

- He never read the guaranty because it was too overwhelming and complex.
- The loan documents were ambiguous.
- The nonrecourse carveout provisions and prepayment premium were unenforceable penalties.
- The entire agreement was unconscionable.

The court held that the guarantor had an obligation to read the guaranty and to retain counsel before signing it, if he did not understand it. Also, the court saw no ambiguity, because the loan documents said the borrower's failure to timely remove a mechanic's lien constituted an event of default that triggered full loan liability under the guaranty.

Even though the prepayment premium was approximately 25% of the principal and about 25 times the amount of the mechanics' liens, the court said it was enforceable as liquidated damages, and was covered by the guaranty. The court enforced the prepayment premium because:

- The loan documents included a recitation of consideration.
- The prepayment premium reasonably measured what the lender lost – many years of interest at a higher rate – as a result of the borrower's default and early repayment of the loan.
- By lending to this borrower, the lender lost opportunities to make other loans.

Finally, the court decided that enforcing the guaranty was not unconscionable because the guarantor had significant business experience and the loan documents clearly provided for personal liability under these circumstances.

Reaction from the Michigan and Ohio State Legislatures

In response to *Cherryland* and *Chesterfield*, the Michigan state legislature easily passed, and the governor signed, all with extraordinary alacrity, legislation called the Nonrecourse Mortgage Loan Act (NMLA) (*Mich. Comp. Laws §§ 445.1591-445.1595 (2012)*). The NMLA expressly prohibits nonrecourse lenders from triggering carveout guaranties based on the borrower's mere insolvency. Though the NMLA became effective on March 29, 2012, it governs both past and future nonrecourse loans. The NMLA does not, however, apply to voluntary bankruptcy filings, including voluntary bankruptcy filings precipitated by insolvency driven by a decline in property values. Thus, voluntary bankruptcy filings can still trigger full loan liability for guarantors in Michigan.

Along similar lines, Ohio promulgated the Legacy Trust Act, effective on March 27, 2013 (*Ohio Rev. Code 1319.07-1319.09*). It virtually tracks Michigan's NMLA, even though no reported Ohio case has produced surprises of the sort found in *Cherryland* and *Chesterfield*.

Cherryland II and After

Nearly six months after the NMLA went into effect, the Supreme Court of Michigan remanded the *Cherryland* case to the state's Court of Appeals to reconsider the issues in light of the new legislation (*493 Mich. 859 (2012)*). On remand, the lender challenged the constitutionality of the NMLA under the Contracts Clause, Due Process Clause, and principles of separation of powers (*835 N.W.2d 593 (2013)*).

The court decided the NMLA did not violate the Contracts Clause, because the NMLA did not cause substantial impairment and the legislature had a significant and legitimate public purpose for the new law, namely preventing the collapse of nonrecourse lending in Michigan.

In response to the lender's due process challenge to the NMLA, the court applied a "rational basis" review, and found no due process violation. The court also cited the legislature's concern that post-closing solvency covenants would prevent developers from qualifying for financing, which could decrease tax revenues.

In its separation of powers argument, the lender argued that, in enacting the NMLA, the legislature essentially commandeered the judiciary's power to interpret carveout guaranties. The court disagreed, saying that no final judgment had been reached because an appeal was still pending when the NMLA became law. Moreover, the Michigan legislature was not directing the outcome of the case, it simply created a law and the court applied the new law.

In *Borman, LLC v. 18718 Borman, LLC*, a Michigan district court reaffirmed the NMLA's constitutionality, rejecting essentially the same three arguments the lender made in the *Cherryland* remand (*2014 WL 943181*). The lender also argued that, by its terms, a nonrecourse loan stops being a nonrecourse loan, and becomes a recourse loan, as soon as the borrower does something that triggers personal liability – so the NMLA would not apply. The court rejected the argument.

FAVORABLE CASES FOR GUARANTORS

Several courts have ruled for the guarantor in the face of extremely technical arguments like those which prevailed in *Cherryland* and *Chesterfield*. In these guarantor-friendly cases, the courts exercised some judgment and recognized the business context of nonrecourse financing and the absurdity of triggering personal liability under circumstances like those of *Cherryland*, *Chesterfield*, *Princeton Park*, and other similar cases.

The Plummer Case

In *GECCMC 2005-C1 Plummer Street Office Ltd. Partnership v. NRFC NNN Holdings, LLC*, a guarantor narrowly escaped a result like those in the *Cherryland*, *Chesterfield* and *Princeton Park* cases (*140 Cal. Rptr. 3d 251 (Cal. Ct. App. 2012)*).

In *Plummer*, the borrower's tenant, Washington Mutual, failed to pay its rent and abandoned the leased premises without the lender's prior consent. The lender said this constituted a prohibited lease termination – and any prohibited lease termination would trigger full loan liability under the governing documents. The trial court granted summary judgment for the lender, but the California Court of Appeals, Second District, reversed that decision, finding for the guarantor.

The appellate court noted that the lease stated by its terms that it "shall not be terminable for any reason by Lessee." Based on that language, neither the tenant's failure to pay rent nor its abandonment of the leased premises could constitute a termination of the lease. By definition, therefore, no lease termination could have occurred, and hence no event could have occurred that could have triggered full loan liability. The court stated that under California law, the lease did not actually "terminate" unless and until the landlord took certain procedural steps to terminate the lease. The *Plummer* court determined that the landlord never took those steps. Thus the lease never actually terminated and the full loan liability carveout never activated.

This favorable result for the guarantor conformed to industry expectations for how carveout guaranties work, because recourse liability depended, as it should, on the borrower's acts (or failures to act) in terminating (or not terminating) the Washington Mutual lease.

The Rincon Case

In *CP III Rincon Towers, Inc. v. Richard Cohen*, a federal court considered the business context and industry standards for a nonrecourse carveout guaranty given in connection with a loan made to renovate a San Francisco apartment building. The court allowed introduction of evidence to show, among other things, that the parties did not intend the filing of a handful of small liens to trigger full loan liability (*2014 WL 1357323 (SDNY 2014)*).

The lender argued that, by its terms, the guaranty triggered full loan liability if both:

- Certain liens totaling over $250,000 were filed against the property without the lender's prior written consent; and
- The loan documents required that consent.

The guaranty and loan documents differed on what types of liens required consent, and when the borrower needed to obtain it. Key terms had conflicting and confusing definitions. After disputes arose during property renovation, mechanic's liens, judgment liens and owners' association liens were filed against the property totaling over $250,000. The lender claimed the liens constituted impermissible transfers, unpermitted indebtedness and voluntary liens under the guaranty, each triggering full loan liability for the guarantor. The court found that the liens were not "voluntary" because the borrower disputed the quality of the work and the amount owed, even though the lender argued that the borrower had enough money to pay the liens but allowed them to be filed, and according to the lender this made them "voluntary."

The guarantor demonstrated that the definitions of "transfer" and "liens" were internally inconsistent within the loan documents, creating ambiguity. The court allowed introduction of extrinsic evidence from the negotiations, showing that all parties intended that the filing of liens of the type at issue here would not trigger full loan liability.

The court also concluded that the loan document provisions on indebtedness did not require the borrower to obtain the lender's consent to incur the indebtedness at issue. The very purpose of the loan was to purchase and renovate a large apartment building, which necessarily required incurring construction costs and other costs to complete. The loan documents did not expressly require lender consent for the borrower to incur association fees or employ contractors, even though both of these actions could create indebtedness. Therefore, these particular actions of the borrower did not trigger full recourse indebtedness under the provisions requiring lender consent to indebtedness.

In the *Rincon* case, the court reached results consistent with industry expectations for nonrecourse financing and the allocation of risks implied in any ordinary nonrecourse loan. At time of writing, the trial court's decision is the subject of an appeal. The author submitted an expert witness report in this case on behalf of the guarantor.

The PETRA CRE CDO 2007-1 Case

In another case that turned out well for the guarantor, a securitized hotel loan began its life as a single $40 million nonrecourse loan. Later, at the lender's request, the borrower cooperated to split the loan into a nonrecourse mortgage loan and a nonrecourse mezzanine loan. The real property secured the mortgage loan. A pledge of the membership interests in the property owner secured the mezzanine loan. Eventually, a foreclosure of the mortgage loan rendered the security for the mezzanine loan worthless. The holder of the mezzanine loan claimed that the mortgage loan foreclosure sale constituted a prohibited transfer under the mezzanine loan, triggering personal liability for the nonrecourse carveout guarantor under the mezzanine loan. The lender argued that although the mortgage itself was not a prohibited transfer, nothing in the mezzanine loan documents expressly made a mortgage loan foreclosure a permitted transfer (*PETRA CRE CDO 2007-1, Ltd v Morgans Group LLC, 84 A.D.3d 614 (App. Div. 2011)*).

Both the trial court and the appellate court rejected the lender's argument. Instead, both courts concluded in essence that the loan documentation and structure of the mezzanine loan contemplated the possibility of a possible mortgage loan foreclosure. Thus it was part of the risk that the mezzanine lender owned by buying into the deal. It was not an extraneous bad act of the type that could legitimately trigger recourse liability.

Again, the courts reached a result consistent with industry expectations, rejecting the lender's very technical argument based on a strict and narrow interpretation of the words on the page. The New York Court of Appeals refused to hear the lender's appeal of the decision (*17 N.Y.3d 711 (2011)*). The author submitted an expert witness report in this case on behalf of the guarantor.

For a visual depiction of a typical mortgage and mezzanine loan structure see *Checklist, Real Estate Mezzanine Lending Chart (http://us.practicallaw.com/2-539-3505)*.

The Palm Beach Mall Case

In a Florida case involving a major regional mall owner, Simon Property Group, L.P. signed a carveout guaranty in connection with a loan secured by the Palm Beach Mall. The lender tried to enforce the carveout guaranty based on three theories (*Wells Fargo Bank, N.A. v. Palm Beach Mall, LLC, 2013 WL 6511651 (Fla. Cir. Ct. 2013)*).

First, the "Special Purpose Entity" covenants required the borrower to remain "solvent." The lender sought summary judgment, arguing that the value of the collateral had dropped below the loan amount, automatically making the borrower insolvent and triggering full personal liability for the guarantor. The court denied summary judgment, saying valuation was a matter of fact. The court also commented that "it is questionable whether Plaintiff would be entitled to summary judgment as a matter of law based on the absence of any case law standing for the proposition that pre-default insolvency triggers the full recourse provisions of the loan." The court footnoted the *Cherryland* and *Chesterfield* cases, noting that no other courts – particularly in New York or Florida – had followed those cases. The court said both cases were "effectively repudiated" by Michigan's NMLA legislation discussed earlier in this article.

Second, the lender argued that the borrower violated the Special Purpose Entity covenants by accepting capital contributions from the guarantor so the borrower could pay its debt service to the lender. These misdeeds, the lender charged, meant that the borrower was not paying its debts from its own funds. The court dismissed the lender's argument as "unpersuasive."

After rejecting the lender's substantive positions on violation of the Single Purpose Entity covenants, and before turning to the lender's third theory of liability, the court took a brief jaunt into legal drafting. The loan agreement defined the term "Special Purpose Entity" – making the borrower liable for breach of "Special Purpose Entity" covenants – but the guaranty triggered full liability only if the borrower failed to maintain its "Single Purpose Entity" status. "Single" is not the same as "Separate," the guarantor argued. The court agreed, effectively destroying a major piece of the carveout guaranty based on sloppiness in the use of a defined term.

The court rejected the lender's argument that the terms "Single" and "Separate" must mean the same thing: "In light of the sophistication of the parties who entered into the Loan Agreement and the Guaranty, the Court finds that the parties knew these terms to have distinct meanings and negotiated their risk accordingly." So, even if the borrower violated the Special Purpose Entity Covenants, that didn't necessarily rise to a violation of the "Single Purpose Entity" requirements – which were not defined at all but, according to the court, were much narrower than "Special Purpose Entity" requirements.

Because "Single" and "Separate" were different words, even if the borrower did violate the "Special Purpose Entity" covenants, the lender could recover only against the borrower, not the guarantor. For another case that likewise turned on drafting, see *Euclid Housing Partners, Ltd. v. Wells Fargo Bank, N.A., 2014 WL 3400624 (Ct. App. Ohio, Eighth Dist. 2014)*, where the Guaranty said the "Borrower" would become fully liable for the loan upon any violation of the single-purpose entity covenants, but didn't directly mention the "Guarantor."

As the third basis to claim full liability against the Palm Beach Mall guarantor, the lender focused on language that made the guarantor personally liable for the whole loan if the borrower committed "gross negligence or willful misconduct." According to the lender, the borrower did exactly that by failing to renew leases and implement its plan to redevelop the mall. The guarantor argued that mere business failures of this type did not "rise to the level of truly culpable conduct" contemplated by the words "gross negligence or willful misconduct." The court agreed with the guarantor, rejecting this claim too.

This third claim made by the lender – reliance on "gross negligence or willful misconduct" to mean almost anything that went wrong with the property – demonstrates that "fraud" and "waste" are not the only words that creative litigation counsel might use to create potential guarantor liability. The lender's efforts to interpret those terms very broadly failed in the *Palm Beach Mall* case, against a backdrop where the court may have had relatively little patience or sympathy for the lender. In some other context, a court might accept a more pro-lender interpretation of "gross negligence or willful misconduct." If a court did that, the lender could claim that practically any violation of the loan documents represents "gross negligence or willful misconduct." Those words may therefore represent another phrase that guarantor's counsel should not automatically accept.

PRACTICAL STEPS GIVEN RECENT CASE LAW

Given the recent case law, guarantors and their counsel must recognize that, if aggressively applied, the convoluted and mutated nonrecourse carveout clauses signed in the pre-2008 boom times may capture far more triggering events than the guarantor, or most likely even the lender, ever anticipated or intended. These cases will force guarantors and their counsel to look at nonrecourse carveouts in a new light. These clauses require ever greater scrutiny, negotiation and fine tuning to assure that tomorrow's guarantors never face surprises of the types described in this Note.

For more information and specific suggestions on negotiation techniques for guarantors and their counsel, see *Practice Note, Commercial Real Estate Loans: Negotiating Carveout Guaranties (http://us.practicallaw.com/2-521-0515)* and *Standard Clauses, Commercial Real Estate Loans: Nonrecourse Carveout Provisions (http://us.practicallaw.com/8-520-8519)*.

In addition, guarantors and their counsel should keep in mind a few more ideas:

The Active Voice

Guarantors and their counsel should remember an old-fashioned grammatical tool for good writers: use the active voice. They should insist that any nonrecourse carveout trigger refer to the borrower's actually causing certain events, rather than the mere occurrence of those events.

For example, in the *Plummer* case, use of the active voice would have prevented a great deal of agony for one (ultimately successful) guarantor. The nonrecourse carveout language at issue in that case could and should have triggered guarantor liability only "if Borrower terminates" the lease in question. If the loan documents used that active voice, the lender could never have argued that a tenant's repudiation of the lease, without more, triggered full loan liability for the guarantor.

In contrast, however, the loan documents in the *Plummer* case used the passive voice. The nonrecourse trigger language referred to whether a lease is "terminated or canceled," ignoring the crucial question of whether just any lease termination or cancelation triggered recourse liability, or instead recourse liability arose only for lease terminations or cancellations that the borrower caused. The only thing that saved the guarantor was the court's technical conclusion that under California law, the lease had never actually terminated.

Definitions and Cross References

Most large transactions require more than just a guaranty document and loan document. Generally several legal documents need to be read together as a whole to show the actual agreement. Although these documents are becoming increasingly complex on their own, these intricacies are further extrapolated when documents must be read in conjunction with one another.

Thus, a drafter must be extremely cautious that defined terms are consistent both within the document itself and across every other document for the transaction. Drafters should also set forth definitions for terms that are used to qualify other defined terms to prevent misinterpretation. In the *Rincon* case, for example, the documents defined "Lien" and used the word "Lien" in defining other terms such as "Transfer" and "Indebtedness," but never defined "Voluntary Lien" or "Involuntary Lien." This allowed the court to interpret "Voluntary Lien" in a way that protected the guarantor but also matched industry standards and expectations.

When multiple documents constitute one agreement, a drafter must ensure that cross-references within a document, and any provisions or definitions incorporated by reference from other documents, correctly reflect the intention of the parties. Some definitions are "broad" and others "narrow," but that will not always be apparent from the defined term itself. So anyone reviewing a set of nonrecourse carveouts should make sure their defined term has the scope they think it should. The risk of misunderstandings and inappropriate cross-references becomes particularly high when the parties negotiate and revise documents on a tight deadline and under pressure to try to close a transaction as soon as possible.

As yet another example of how broad definitions can lead to surprises for guarantors, in *ING Real Estate Finance (USA) LLC v. Park Avenue South Acquisition LLC*, a guarantor paid off a tax lien 19 days after it was filed against the property (*26 Misc.3d 1226(A) (2010)*). Under the intricate set of defined terms in the loan documents, "Indebtedness" was defined to include liens, but one provision allowed a 30 day notice and cure period for indebtedness, while another provision immediately triggered full recourse liability for indebtedness. The court did not enforce full loan liability because New York law construes the terms of a guaranty in favor of a guarantor. Moreover, the court said the alternative interpretation, where a guarantor would be liable for the full loan amount for being one day late to pay one dollar, would be commercially unreasonable.

Going a step further, guarantors and their counsel should beware of allowing complex piles of intertwined defined terms to create personal liability. The route to personal liability should be clear, certain and readily comprehensible, allowing borrowers and guarantors to understand and confirm that only truly egregious actions by the borrower – within the guarantor's control – can lead to personal liability.

Existing Guaranties

Guarantors who have already signed and delivered nonrecourse carveout guaranties should act with great care and caution. As soon as a property starts to suffer from financial problems, and probably even before then, guarantors should review with counsel the nonrecourse carveout clauses in their loan documents. Above all, the guarantor should never let the borrower do anything that might even arguably trigger carveout liability, particularly full loan liability, under any possible interpretation of the carveout clause, even a very stretched and hypertechnical interpretation. Although some of the cases have come out in favor of guarantors, guarantors should never assume the courts will "get to the right place." Lenders have won more of these cases than have guarantors.