BNA, INC.

# REAL ESTATE LAW & INDUSTRY

REPORT

Reproduced with permission from Real Estate Law & Industry Report, 2 REAL 1000, 11/03/2009. Copyright © 2009 by The Bureau of National Affairs, Inc. (800-372-1033) http://www.bna.com

RECOURSE LIABILITY

*Nonrecourse carveout guaranties were a common element in most commercial real estate loans for the last decade or two. Now those guaranties are finding their way into the courts. So far, the courts seem to be quite willing to enforce them. Here the author analyzes a recent New Jersey case along those lines, and looks at some defenses the guarantors offered and the courts rejected. The author warns guarantors that they need to understand exactly what might trigger recourse liability and proceed with care. Both borrowers and lenders will probably use their magnifying glasses to take a hard look at the words of any nonrecourse carveout guaranty.*

## Caveat Guarantor: Courts Rule Nonrecourse Carveouts Mean What They Say

BY JOSHUA STEIN*

Courts won't really enforce nonrecourse carveout guaranties, will they?

Lenders weren't entirely sure they would. Guarantors hoped they wouldn't. And now that commercial real estate has hit a brick wall, the courts are providing some answers to the question.

In an August 2009 case, *CSFB 2001-CP-4 Princeton Park Corporate Center, LLC v SB Rental I, LLC,*[1] for example, a New Jersey appellate court looked at the words of a carveout guaranty, applied them to the facts, and affirmed a substantial judgment against the guarantor (2 REAL 895, 9/22/09). The court rejected various theories and arguments that the guarantors offered, concluding that the guaranty contract spoke for itself and should simply be enforced.

The *Princeton Park* decision continues a trend seen in other states. To the pleasant surprise of lenders, courts have shown a willingness to enforce carveout guaranties in accordance with their terms.

* Joshua Stein, a real estate and finance partner at Latham & Watkins LLP and a board member of this publication, writes extensively about commercial real estate law and practice. For more information, visit www.real-estate-law.com. Any views expressed in this article do not necessarily reflect the views of the author's clients, the author's firm, or anyone else; and may change at any time.

[1] 2009 N.J. Super. Lexis 199 (N.J. Superior Court, App. Div., Aug. 11, 2009).

The background of *Princeton Park* is familiar to anyone who closed commercial real estate loans during the late real estate boom. In May 2001, an affiliate of Credit Suisse First Boston loaned $13.3 million to a single-purpose entity (SPE) on a nonrecourse basis. The principals of the borrower (Guarantor) agreed: ''Guarantor shall be liable for the full amount of the Debt in the event that . . . Borrower fails to obtain Lender's prior written consent to any subordinate financing or other voluntary lien encumbering the Mortgaged Property.''

In May 2004, the borrower obtained a loan of $400,000, secured by a subordinate mortgage on the collateral, without obtaining the lender's consent. Before the end of the year, the borrower repaid that mortgage in full, but no one released it of record.[2]

In May 2006, the Credit Suisse First Boston loan went into default. It remained in default thereafter. The lender foreclosed, then sought a deficiency judgment against the guarantors, arguing that the loan had become ''full recourse'' to the guarantors as a result of the small subordinate mortgage, even though it had been paid in full within less than a year.

**Breach 'Unrelated to Damages.'** The guarantors argued that the brief existence of the second mortgage inflicted no harm on the lender. The guarantors believed, as the court summarized it, that any breach caused by the subordinate mortgage was ''unrelated to any damages suffered by [the lender] and therefore the non-recourse carve-out clause extracted an unenforceable penalty in this instance.''

The trial court found, and the appellate court agreed, that the nonrecourse carveout guaranty was not a penalty at all, but merely part of the agreement between the parties. The conditions of the guaranty simply determined whether the lender had to limit its recovery to the property or could also proceed against the guarantors' personal credit, as the source for repayment of a loan the amount of which was not in debate.

The guarantors tried to invalidate the guaranty based on a liquidated damages theory. Both the trial court and the appellate court rejected that argument, saying that ''liquidated damages'' did not offer the right analytical approach to the issue. In the words of the appellate court, the trial court found that ''the damages sought by plaintiff were neither speculative nor estimated, but actual . . . ('equal to the outstanding loan balance and nothing more') and fair . . . ('[t]he defendants hav[ing] received the benefit of their bargain by receiving and retaining the loan proceeds').''

So the usual first premise for assessing liquidated damages—the requirement that damages be difficult to measure and ascertain—didn't apply here. The damages were perfectly measurable. ''Such an amount is fixed by the terms of the loan and is therefore neither speculative nor incalculable.'' And the activation of the guarantors' recourse liability had nothing to do with the measure of damages; it operated ''principally to define the terms and conditions of personal liability, and not to affix probable damages.'' The only issues were who was liable for actual damages and when they became liable. The parties had resolved these issues in the words of their contract.

**Court Rejects Guarantor's Argument.** The guarantors also argued that even if the prohibited subordinate mortgage made them personally liable for the loan, any such liability should end as soon as the borrower repaid the prohibited subordinate mortgage. The court rejected that argument, too, saying that when the borrower recorded the mortgage, that constituted a breach and irrevocably triggered carveout liability. In the words of the court:

> [T]he fact that the subordinate financing was paid off well before defendants' ultimate default on payment of the principal loan does not alter the fact that defendants breached the very obligation identified by both parties as posing a special risk to plaintiff, and therefore requiring the covenant's special protection [i.e., the nonrecourse carveout]. By further encumbering the property, even if only temporarily, defendants' action had the potential to affect the viability and value of the collateral that secured the original loan. Indeed, it cannot be said with any certainty that the subordinate financing in this case was entirely unrelated to defendants' ultimate default on their mortgage payments. In any event, the fact that such potential may not have actualized does not diminish the breach of obligation nor vitiate its contracted-for consequences. Having freely and knowingly negotiated for the benefit of avoiding recourse liability generally, and agreeing to the burden of full recourse liability in certain specified circumstances, defendants may not now escape the consequences of their bargain.

Strong words. The court cited several recent cases from other jurisdictions reaching much the same result, and in some instances similarly refusing to give the guarantors a judicial ''opportunity to cure'' in order to prevent recourse liability.[3]

Cases like *Princeton Park* signal that guarantors should assume courts will generally enforce carveout guaranties in accordance with their terms. The facts of *Princeton Park* and the guarantors' arguments offered ample opportunities for the courts to cite considerations such as equity and fairness and to conclude that the guarantors shouldn't really have to pay under their guaranty. The courts unambiguously declined all those opportunities, ruling for the lender based on a straightforward interpretation of the words of the guaranty.[4]

**Lenders Will Look for 'Recourse Carveouts.'** Going forward, lenders will probably redouble their efforts to identify ''recourse carveout'' events based on the words

---

[2] If someone had released the subordinate mortgage, it probably would not have appeared on the lender's foreclosure search. Unless the lender found out about it some other way, the lender might not have known about the factual premise for a claim against the guarantors.

[3] *FDIC v. Prince George Corp., 58 F.3d 1041, 1046 (4th Cir. 1995)* (sustaining recourse liability triggered by voluntary bankruptcy filing; not a violation of public policy); *First Nationwide Bank v. Brookhaven Realty Assocs., 223 A.D.2d 618, 637 N.Y.S.2d 418 (N.Y. App. Div.)*, *appeal dismissed*, *88 N.Y.2d 963, 647 N.Y.S.2d 715, 670 N.E.2d 1347 (1996)* (dismissal of bankruptcy proceeding after 90-day cure period did not vitiate personal liability); and *Blue Hills Office Park LLC v. J.P. Morgan Chase Bank, 477 F. Supp. 2d 366, 377-383 (D. Mass. 2007)* (borrower's diversion of zoning dispute settlement payment constituted a prohibited transfer of collateral; this triggered recourse carveout). Other courts in other states—even California—have reached similar conclusions, but this article is not intended as a general overview of the law in this area.

[4] Some commentators have suggested *Princeton Park* may be further appealed. Those who pay attention to these issues should watch for any such appeal and its result.

 COPYRIGHT © 2009 BY THE BUREAU OF NATIONAL AFFAIRS, INC.  ISSN 1944-9453

of all available guaranties. This could produce further unpleasant surprises for guarantors.

For example, some guaranties make the guarantors personally liable for the entire loan if the borrower does not comply with the SPE covenants in loan documents—often with no cure period, materiality threshold, or other mitigating protections for the guarantors. Under a strict guaranty of this type, if the lender can find any violation of the single-purpose entity covenants, it would have a decent argument for full personal liability for the loan, based on cases like *Princeton Park* (For example, did the borrower share its letterhead or its telephone number with its affiliates? If so, perhaps now the guarantors are personally liable!)

Bankruptcy filings will provide fertile ground for these claims under carveout guaranties. A minority of carveout guaranties impose personal liability for any bankruptcy filing by the borrower—even an involuntary filing. The logic of *Princeton Park* suggests if that's what the guaranty says, then that's what it means. The guarantor might become personally liable for the entire loan even if the lender was the party that instigated the involuntary bankruptcy filing.

More recent or more successfully negotiated carveout guaranties of this type often trigger personal liability only upon a voluntary filing or an involuntary filing initiated with the collusion or participation of the borrower or its principals. Words like these can mean many things.

One can anticipate lenders will explore the history of any involuntary bankruptcy filing, to see if the borrower or its principals in any way facilitated the filing. If they did, then the lender would use those facts to support a claim for personal liability for the loan.

For example, what if the unsecured creditors who filed the petition asked the borrower for an updated balance sheet with detailed schedules and information about the borrower's accounts payable so they could assess their likelihood of being paid? If the borrower complied with the request, and the unsecured creditors used the information to solicit other creditors to join the filing, are the guarantors now personally liable for the entire loan? Very likely so, depending on how the court characterizes the facts of the particular case.

The apparent ''pro-lender'' view of the courts in enforcing carveout guaranties should come as no great surprise to the commercial real estate industry. The *Brookhaven Realty* case cited by the *Princeton Park* court was decided more than 10 years ago, and it applied much the same literal interpretation of the words of the guaranty (triggering personal liability as the result of a bankruptcy filing).

Careful guarantors seem thus far to have guided themselves accordingly in cases where they have signed carveout guaranties triggered by various species of bankruptcy filing or other interference with the lender's enforcement of its rights and remedies. This may explain the paucity of commercial real estate bankruptcy filings to date, disregarding some highly visible real estate-related ''corporate'' filings. It may also explain the cooperative posture of some prominent defaulted borrowers who one might have expected to litigate aggressively to protect their investments.

**More Surprises in Store.** Further surprises probably lurk within carveout guaranties. The entire topic will likely become[5] one of the ''main events'' in dealing with troubled loans, potentially both a great opportunity for lenders and a great problem for guarantors.

As another example, consider a guarantor who assumed personal liability for certain possible ''bad acts'' that a mortgage borrower might commit (theft of property income or fixtures, voluntary bankruptcy filing, etc.). Now add on a layer of mezzanine financing, backed by a pledge of all the equity interests in the mortgage borrower.

If the mezzanine financing goes through foreclosure, the guarantor no longer owns its interest in the borrower, and thus can no longer control what the borrower does. If the borrower, now controlled by the former mezzanine lender (or the successful bidder at a mezzanine foreclosure sale), performs ''bad acts,'' the guarantor may find itself personally liable for the loan, even though the guarantor can no longer prevent the ''bad acts.'' Of course, some guarantors identified this issue even under the compressed closing schedules of 2003 to 2007 and included protective language in their guaranties. But many didn't, or couldn't, or wanted their counsel not to waste time and legal fees on weird hypothetical eventualities.

Guarantors will also face surprises when the courts don't quite ''get'' the language of the guaranty exactly right. For example, in a federal court case in Alabama,[6] the court considered a typical carveout guaranty, imposing on the guarantor personal liability (an obligation to indemnify the lender) for any ''waste'' committed by the borrower (2 REAL 693, 6/30/09). So far so good.

After the guaranty defined the ''carveout'' events that would trigger personal liability, the guaranty then included the usual hundreds of words of standard language that has accreted over the years in response to previous court rulings in favor of guarantors. That language included the following statements (''Green'' being the guarantor and ''Gaslight'' the borrower):

> This is a guaranty of payment and performance and not of collection. The liability of [Green] under this Agreement shall be absolute, direct and immediate and not conditional or contingent upon the pursuit of any remedies against [Gaslight] or any other person (including, without limitation, other guarantors, if any), nor against the collateral for the Loan. [Green] waives any right to require that an action be brought against [Gaslight] or any other person or to require that resort be had to any collateral for the Loan or to any balance of any deposit account or credit on the books of Potomac in favor of [Gaslight] or any other person. . . . If the indebtedness and obligations guaranteed hereby are partially paid or discharged by reason of the exercise of any

[5] One might ask whether ''become'' is the right word choice, if in fact carveout guaranties are already a ''main event'' in dealing with troubled loans. Fortunately, the New York Court of Appeals has indicated that this word choice is entirely appropriate, because in New York the verb ''become'' also includes ''remain'' or ''continue to be.'' In other words, if the author is already unquestionably overweight, he can still ''become'' overweight by eating too much chocolate mousse. *See Roberts v. Tishman Speyer Properties, L.P.*, Decision No. 131, New York Court of Appeals (Oct. 22, 2009), at page 12 of typed decision as issued by the Court (''there is nothing impossible, or even strained, about reading the verb 'become' to refer to achieving, for a second time, a status already attained'').

[6] *Potomac Realty Capital, LLC v Green*, Case No. 2:08-cv-204-MEF (unpublished, June 2, 2009).

> of the remedies available to [Potomac], this Agreement shall nevertheless remain in full force and effect, and subject to the terms hereof, [Green] shall remain liable for all remaining indebtedness and obligations guaranteed hereby, even though any rights which Green may have against Gaslight may be destroyed or diminished by the exercise of any such remedy.

**'Plain Language' of Guaranty.** The court interpreted the ''plain language'' of the guaranty—apparently, the language quoted above—to make the guarantor personally liable for any deficiency in the loan remaining unpaid after foreclosure, and not just liability for waste.

In the author's view, the language quoted above has nothing to do with defining the scope of the guarantor's liability, but relates solely to preserving that liability—whatever it is after having been initially defined—if the lender enforces other rights or remedies. Also in the author's view, the guarantor's liability was without doubt intended to be limited to the specific ''carveout'' matters (such as waste) initially provided for in the guaranty.[7]

The carveout guaranty at issue in the *Green* case was quite ordinary, typical, and customary. Thus, if the *Green* court was correct that the guaranty boilerplate converted a ''carveout'' guaranty into a ''deficiency'' guaranty, many thousands of carveout guarantors from coast to coast may face similar exposure. Unfortunately for them, no national association of carveout guarantors stands ready to file an amicus brief for an appeal of the *Green* decision.

The *Green* case should also invite lenders to scour the boilerplate of their guaranties to look for language they can use as the basis for finding the guarantor fully liable for the entire loan, just as the *Green* lender successfully did.

Few of the developments described in this article come as good news for borrowers and guarantors. As the real estate meltdown of 2009 continues, guarantors need to understand exactly what they signed and make sure they steer clear of any circumstances that a court could conceivably treat as triggering personal liability for the loan. Conversely, lenders should review the guaranties they hold, read and master the words that create personal liability for the guarantors (as well as the ''boilerplate'' that no one looked at very closely), and identify circumstances or language that might support a claim for personal liability. The court doors do seem to be quite open to such claims.

**Cases Found in State Courts.** As an important footnote to this entire discussion, acceptance of carveout guaranties has thus far come through the state courts—not federal bankruptcy courts. The bankruptcy courts may well have a different view of at least some of the common nonrecourse carveouts, particularly carveouts that create full personal recourse for the borrower's principals if the borrower files bankruptcy.

Some lenders and lenders' counsel fear that a bankruptcy judge may treat that particular species of carveout as a ''back door'' way to try to prevent the borrower from filing bankruptcy and from obtaining whatever private and public benefits bankruptcy is supposed to deliver. On such grounds, bankruptcy courts might decide to invalidate bankruptcy-triggered carveout guaranties, assuming they can assert sufficient jurisdiction to do so.

Recent bankruptcy decisions spawned by the late commercial lending boom suggest that the bankruptcy courts will not hesitate to figure out who are the ''bad guys'' in any transaction, and then throw the book at them. Some bankruptcy courts seem to have decided the ''bad guys'' are the lenders who closed highly leveraged transactions, as opposed to the borrowers who took the money or the other creditors who chose to deal with those borrowers. If a similarly goal-oriented bankruptcy court decided the lender that held a carveout guaranty was the ''bad guy'' in a transaction, it would not come as shock to see the bankruptcy court try to figure out a way to set aside the guaranty.

The bankruptcy courts seem most likely to have this opportunity if the guarantor itself were a debtor under the bankruptcy code, in which case the guaranty would constitute an unsecured obligation and hence provide little value to the lender anyway. Even if the guarantor were not itself subject to a bankruptcy proceeding, though, an aggressive bankruptcy court might try to rely on Bankruptcy Code Section 105 to set aside a carveout guaranty (triggered by a debtor borrower's bankruptcy) that the court regarded as egregious and against public policy. Thus far, to the author's knowledge, this has not happened.

If it were to happen, it would reinvigorate bankruptcy as a refuge for real estate borrowers, at least if they could persuade their particular bankruptcy judge to reach the same result, and sustain that result on appeal if necessary. Guarantors should not hang their hat on that possibility, but lenders should keep it in the back of their mind.

---

[7] The note, mortgage, and guaranty appeared in the court file. The author obtained and reviewed those documents. They do not change the author's conclusion that the court incorrectly converted a ''carveout'' guaranty into a full guaranty of principal.

 COPYRIGHT © 2009 BY THE BUREAU OF NATIONAL AFFAIRS, INC.  ISSN 1944-9453