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Contents

Non-Recourse Carveouts

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The underlying principle of a *non-recourse* loan–the feature that seduces borrowers into paying higher interest rates, succumbing to greater lender oversight, and agreeing to keep the collateral asset sufficiently isolated from a borrower's parent and affiliates–is that, in the event of a borrower default, the lender's only remedy is to foreclose on the pledged collateral. That is to say, the lender does not have *recourse* against the borrower or any guarantor; the lender bears the risk that the value of the collateral may someday be less than the amount borrowed.

In every non-recourse loan, of course, there are exceptions to this feature. These so-called *carveouts* are events or circumstances that trigger recourse against the borrower and, commonly, one or more guarantors.

The carveouts generally fall into one of two categories: (1) those that cause the borrower and guarantors to be liable for the entire outstanding balance of the loan (*full-recourse*), and (2) those that cause the borrower and guarantors to be liable for the amount of damage incurred by lender as a result of the trigger event or circumstance (*loss recourse*).

Any borrower considering a loan containing non-recourse carveout provisions should engage counsel during the negotiation of the loan commitment, rather than waiting until the commitment is signed. The commitment will list, with varying degrees of detail, the non-recourse carveouts that will be included in the ultimate loan documents; negotiating the carveouts at the application stage will provide a borrower greater leverage than waiting until after the application has been signed and the loan documents generated. Additionally, lenders seem to be constantly attempting to increase the number and scope of typical non-recourse carveouts, so a lawyer's careful review of the application may result in completely eliminating or dramatically scaling-back one or more of the carveouts.

I. Typical Carveouts

Following is a collection of some of the most common non-recourse carveout provisions, with some commentary regarding important negotiation considerations. This is not a complete listing, but rather a sampling of those that tend to get the most attention.

A. Loss Recourse Provisions

A borrower or guarantor may be liable to the lender for the amount of loss incurred by such lender arising out of:

1. *Fraud, gross negligence, willful misconduct or intentional misrepresentation or any failure to disclose a material fact by borrower or guarantor in connection with the making of the loan;*

It is important to understand and adequately limit to whom the foregoing carveout extends. A lender will attempt to include affiliates and representatives of borrower and guarantor, which may be problematic if not carefully considered. Certainly, the affiliate or representative must, at a minimum, be vested with a reasonable presumption of authority to act on behalf of borrower; otherwise a fraudulent statement sent to lender from any employee of

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borrower with an axe to grind, for example, could potentially trigger recourse under this provision.

2. *the commission of a criminal act by borrower, guarantor, or any borrower party* [typically this provision applies to officers or principals of borrower or guarantor];

The term "criminal act" is woefully vague, but the risk is manageable provided it is a loss recourse (and not full recourse) carveout, since liability would only be triggered to the extent the lender actually incurs a loss as a result of the criminal act. Nonetheless, some borrowers ask for, and often receive some variation of the following modifying clause, which reduces the careveout's potential applicability even further: "which results in any seizure or forfeiture of the Property, or any portion thereof, or Borrower's interest therein."

3. *material physical waste to the Property caused by the intentional acts or intentional omissions of borrower, guarantor, or any borrower party and/or the removal or disposal of any portion of the Property after an event of default by borrower, guarantor, or any borrower party;*

This carveout will sometimes be even broader, applying to Borrower's failure to maintain the property in first class condition. It is best to revise to make the liability arise only in the event of intentional waste, and further, seek to add a proviso that imposes such liability only to the extent the property is generating sufficient cash flow to prevent the occurrence of such waste. Put another way, if borrower allows or causes the property to deteriorate into poor condition, it should only be liable to lender to the extent money was available from the operation of the property to prevent such deterioration and then only if it was willful.

4. *the misapplication, misappropriation or conversion by borrower of any rents generated by the Property following an event of default or of any security deposits, advance deposits or any other deposits collected with respect to the Property;*

The misapplication carveout has a nuance that is often overlooked but extremely important: the provision needs to be modified to apply only to rents collected by borrower during an ongoing and *uncured* event of default, or, alternatively, rents collected following an event of default for which lender has taken affirmative enforcement actions. Under the unmodified provision written above, it is possible that the borrower may technically default under the loan documents, that lender does not seek to enforce any remedies as a result of such default and the default is cured by the borrower, but nonetheless the borrower is liable to the lender for any rents it received following such technical default (no matter how long after it has been cured) that it disbursed to its members. In addition to ensuring the carveout relates only to uncured events of default for which no enforcement action has been taken, borrowers are recommended to further modify the language to specifically permit rents received following an uncured event of default to be applied to the payment operating expenses of the property (including debt service).

5. *failure to pay any taxes, charges for labor or materials or any other charges that can create liens on any portion of the Property;*

This common carveout needs to be limited to apply only to the extent that the revenue from the property is sufficient to pay such amounts (other than (x) amounts deposited with the lender into a tax reserve escrow, (y) taxes owed that are contested strictly in accordance with the terms of the loan documents or (z) liens arising from charges for labor or materials or any other charges that are contested strictly in accordance with the terms of the loan documents);

6. *the breach of any representation, warranty, covenant or indemnification provision in the Environmental Indemnity, this Agreement or in the Security Instrument concerning Environmental Laws or Hazardous Substances;*

The environmental liability carveout is an acceptable risk for most borrowers; however, it is possible to spend a fair amount of negotiation capital attempting to limit the life of potential liability under the environmental indemnity agreement. Some borrowers succeed in imposing a sunset of two years on all liability arising under such indemnity agreement provided the borrower produces a new environmental report showing no new concerning environmental conditions first arising during the borrower's period of ownership.

7. *failure to maintain insurance as required by this Loan Agreement;*

This is another example of a carveout that is not offensive in concept, but that needs to be qualified so that it only applies to the extent that the revenue from the property is sufficient to pay the required insurance premiums (other than the failure to pay amounts which may have been escrowed with the lender for payment of insurance premiums where the lender elects not to apply such funds toward payment of such insurance premiums).

8. Borrower's breach of, or failure to comply with, the special purpose entity ("SPE") provision of the loan agreement.

This is a provision that often begins as a full recourse carveout in a lender's first draft loan commitment or loan agreement. Some borrowers view this as a loss recourse provision, since breaches are unlikely the result of any true ill-intent of the borrower; or, at a minimum, breaches of certain of the SPE requirements should be loss recourse and breaches of certain other of the SPE requirements might be reasonably included among the full-recourse carveouts. Special attention should be paid, of course, to the borrower SPE requirements contained in the loan agreement, which underlie this carveout.

B. Full Recourse

Of course, there are some actions that are so egregious that they trigger not only loss recourse to the borrower and guarantors, but full recourse for the entire outstanding amount of the loan. Most borrowers believe that such full-recourse carveouts should be limited to true "bad boy" acts that result from the intentional misdeeds of a borrower. These often include bankruptcy, "admitting in writing," non-permitted transfers, and violation of SPE provisions, each of which are considered below:

1. Borrower's filing for voluntary bankruptcy, insolvency, receivership or similar proceeding.

This carveout will appear in every full-recourse provision, and it is going to be non-negotiable; however, a guarantor that does not control the borrower may seek to remove itself from full-recourse under this provision in the instance where borrower voluntarily files for bankruptcy and guarantor actively opposes such filing.

2. Any involuntary bankruptcy, insolvency or receivership proceeding is filed against the borrower, and such action is not dismissed within sixty (60) days of filing.

The foregoing provision should always be limited to proceeds to which borrower has conspired with the filing creditors or to which borrower fails to actively oppose, since otherwise the event is outside the control of borrower and therefore should not be considered borrower's "bad act."

3. Borrower's admission in writing or in any legal proceeding its insolvency or inability to pay its debts.

This full-recourse carveout has all the trappings of a so-called "gotcha" provision, similar to the SPE provisions discussed in greater detail below. Without modification, this provision would make a debt fully recourse to borrower and any guarantor if borrower were to send a letter to lender stating it cannot make debt service payments due to a decrease in cash-flow generated at the collateral property. Similarly, if during a foreclosure proceeding a borrower were to state it cannot make debt service payments, such statement could trigger full-recourse under the carveout as drafted. This is clearly the wrong result and completely counter to the purposes and intention of a non-recourse loan, whereunder a lender must look solely to the collateral property if a borrower defaults on debt service payments. If a property is not generating enough cash to make debt service payments, why should merely stating this to be the case trigger full recourse (while remaining silent would not)? Borrower's counsel should make sure debt service payments are clearly excluded from this carveout, and should attempt to make it a loss-recourse event rather than full-recourse, or at a minimum that such admission may only result in full-recourse if it results in the substantive consolidation of the assets of borrower.

4. Any transfer of the property that is not a permitted transfer.

The transfer carveout needs to be carefully considered on a case-by-case basis. Certainly, deeding the property without lender's consent or knowingly transferring the control of the borrower without lender's consent may properly be considered full-recourse events, but what about non-material non-permitted transfers of an ownership interest in borrower? Or entering into a small, non-material lease (or any lease for that matter on market terms)? Condemnation? Many of the foregoing may successfully be either excluded completely from the recourse provisions or, at a minimum, negotiated down to loss-recourse events rather than full-recourse.

5. Borrower's failure to comply with the special purpose entity provisions of the loan documents.

In the next section, the importance of paying close attention to the SPE provisions is discussed in more detail. In light of the case law, borrower's counsel should demand that a violation of the SPE provisions be re-classified as a loss-recourse event. If such a re-classification is not possible (and even if it is), counsel should pay extra close attention to each and every SPE covenant, ensuring that language is added where appropriate to ensure that any requirement of borrower to expend money is limited clearly to the extent that borrower has sufficient cash flow

generated from the operations of the collateral property to pay such expense.

II. Obligatory *Cherryland* Discussion

Much has been written about the infamous *Cherryland*[1] and *51382 Gratiot*[2] decisions. These decisions sent shockwaves through the lending universe, since they seemed (to many observers) to legitimize lenders' attempts to skirt the spirit of a non-recourse loan. As a result, SPE requirements have become some of the most heavily scrutinized provisions in non-recourse loan documents by borrowers concerned with falling victim to a "gotcha"-type recourse pitfall. Put broadly, each court held that a borrower's failure to remain solvent was in literal contravention of the SPE requirements contained in their respective loan documents, and therefore properly triggered full-recourse remedies under the loans (since failing to comply with each loan's SPE provisions was in both cases a full-recourse trigger event under the applicable loan documents). According to the court in *Cherryland*, the mere fact that a borrower's collateral declined in value to less than the amount owing on the loan (resulting in insolvency) was sufficient to trigger recourse liability if the loan documents contained a covenant of borrower to remain solvent.

Also well-known in the mortgage lending world is how quickly the Michigan legislature responded with *retroactive* legislation to counter-act the lender-friendly case law.[3] The Michigan Nonrecourse Mortgage Loan Act ("NMLA") prohibits any post-closing solvency covenant on the part of borrower from being used as a nonrecourse carveout or as a basis for any claim against a borrower or guarantor on a nonrecourse loan and invalidates any such provisions contained in existing loan documents.[4]

The legislature justified the NMLA by noting that the use of insolvency as a nonrecourse carveout "is inconsistent with the nature of a nonrecourse loan; is an unfair and deceptive business practice and against public policy; and should not be enforced."[5]

III. Conclusion

Borrowers and guarantors, and their respective counsel, should not be comfortable relying on a loan's classification as "non-recourse"; as described in the pages above, the non-recourse nature of a loan can quickly turn to partial or even full recourse in a number of perhaps unexpected instances. Obviously, counsel should review carefully all aspects of a set of loan documents, but particular sensitivity is necessary when reviewing the non-recourse carveouts and any loan provisions upon which such carveouts are based, notably the SPE provisions. Without careful review and dogged negotiation, the "non-recourse" quality of a loan can be very flimsy indeed, putting borrowers and guarantors at great economic risk that likely is not expected or properly weighed by them while assessing whether to enter into a loan transaction.

1 *Wells Fargo Bank, NA v Cherryland Mall Ltd P'ship*, 295 Mich App 99; 812 NW2d 799 (Mich Ct. App 2011). In *Cherryland*, the lender–or rather, the special servicer–pursued the borrower and guarantors for a multi-million deficiency claim following a foreclosure on the mortgage securing the underlying loan obligation of borrower. The loan was non-recourse, except for the typical litany of carveouts. Among the bankruptcy-remoteness covenants undertaken by borrower in the loan agreement was a covenant to "remain solvent . . . and pay its debts and liabilities . . . from its assets as the same shall become due." The borrower and guarantor had agreed that the loan would become fully recourse if the borrower failed "to maintain its status as a single purpose entity as required." In finding in favor of the lender, the court employed a literal interpretation of the loan documents, reasoning that full-recourse had been triggered since (i) borrower had become unable to pay its debts when due, (ii) such failure was a breach of the SPE covenants in the loan agreement, and (iii) a breach of the SPE covenants was a clear trigger of a full-recourse carveout.

2 *51382 Gratiot Avenue Holdings, LLC vs. Chesterfield Dev Co, LLC*, 2011 WL 6153023, 2001 US Dist LEXIS 142404 (ED Mich, Dec 12, 2011) Similarly to *Cherryland*, the court in *51382 Gratiot* sided with the lender, who sought to seek recourse liability against the guarantor following a mortgage foreclosure that resulted in a sizable deficiency (roughly $12 million). The loan agreement provided that the loan would become fully recourse to borrower and guarantor if ever borrower should "become insolvent or fail to pay its debts and liabilities from its assets as the same shall become due." The lender claimed, and the court agreed, that the foregoing provision was violated when borrower was no longer able to make debt service payments.

3 *See Michigan Nonrecourse Mortgage Loan Act*, MCL Sec. 445.1591 et. seq. The legislation was signed into law 94 days after the *Cherryland* decision, to the chagrin of lenders everywhere.

4 Working with impressive expediency, the Michigan Supreme Court, on September 20, 2012, remanded *Cherryland* to the Michigan Court of Appeals to be considered in light of the passage of the NMLA. *Wells Fargo Bank, NA v Cherryland Mall Ltd P'ship*, 493 Mich 859; 820 NW2d 901 (2012). In the remanded case, the Court of Appeals quickly considered and upheld the constitutionality of the NMLA, ruling in favor of the defendants (borrower and guarantor). 300 Mich App 361; 835 NW2d 593 (2013) (on remand).

5 MCL 445.1591.