Non-recourse Loans—A Dangerous Misnomer

by Lydia C. Stefanowicz

Historically, in the context of commercial real estate mortgage loans, a non-recourse loan was one where the lender agreed to look solely to the mortgaged property and any related collateral for repayment of the loan in the event of a default. It was a simple concept; no exceptions. The non-recourse loan structure originally emerged in response to the tax advantages it offered a borrower, but over time it became a common structure for mortgage loans without regard to tax benefits. However, although the designation 'non-recourse' continues to be used widely, truly non-recourse commercial mortgage loans have not been seen since about the early 1980s. Over time, exceptions—recourse carve outs—have developed, as a result of which the borrower and guarantors incur personal liability. The borrower in a non-recourse loan is not permitted to own any other properties or conduct any other business, which leaves the borrower unable to satisfy any liabilities beyond those that can be paid from either cash flow from the property or liquidation of the collateral. As a result, it is the guarantors who are left with the risk of the liability from recourse carve outs.

Recourse carve outs are of two types, differentiated by their consequences. First, there are the events that give rise to personal liability on the part of the borrower and guarantors for actual damages suffered by the lender as a result thereof, but still impose no liability for the debt. Second, there are the events that trigger full recourse personal liability for the debt on the part of the borrower and guarantors. Since the early 1980s, the ability of borrowers and guarantors to limit their personal liability in connection with a commercial real estate mortgage loan has been increasingly diminished, to the point that describing some of these loans as non-recourse is a misnomer today.

In a non-recourse loan, the lender, on the basis of its assessment and analysis of a property (typically referred to as its underwriting), has agreed to bear the risk that the property may decline in value below the amount of the indebtedness secured, as a result of market fluctuations or other circumstances beyond the borrower's control. On that premise, the original recourse carve outs were for so-called 'bad boy' acts such as fraud or material misrepresentation, misappropriation of rents, misappropriation of casualty or condemnation proceeds and physical waste of the mortgaged property. These bad boy acts undermined a lender's underwriting of the property. It was difficult to argue that these deliberate acts, which are within the borrower's or guarantors' control, should be permitted with impunity. Environmental matters were also carved out by lenders because of the difficulty of quantifying the likelihood, scope and extent of liability as a result thereof.

Each of these carve outs was relatively simple and easy to understand, and a borrower's liability was limited to the actual damages suffered by the lender from the triggering event, not the entire indebtedness. Bankruptcy (either voluntary or involuntary if it arose from collusion with other creditors) was added to the list as a full personal liability trigger after it was utilized by borrowers and guarantors in the real estate depression of the 1990s to hinder and impede a lender's exercise of remedies. Still, the rationale was that the bankruptcy was within the control of the borrower and guarantors.

The list of recourse carve outs has grown over the years, and the traditional recourse carve outs have been expanded to broaden the liability of borrowers and guarantors. Misappropriation of funds now covers not only rents and insurance or condemnation proceeds, but also security deposits and lease termination fees. Liability for environmental matters can now be triggered by the presence of substances that are not even regulated, for example, mold. Recent commercial mortgage-backed securities (CMBS) loans also have added more triggers for liability. Failure to timely pay taxes and insurance (whether or not the cash flow from the property is sufficient), failure to pay ground rents or reciprocal easement agreement charges, and failure to timely furnish the lender with financial statements and other required reports are all now seen on lists of non-recourse carve outs.

Not only are there more recourse carve outs and triggering events that are broader in scope, but often the triggering events are stated in a way that does not require an affirmative action by a borrower or guarantor. For example, criminal activity at the property by a tenant or other third party may be a triggering event. And the triggering events are more likely now to create full recourse personal liability for the entire indebtedness rather than liability only for the lender's actual damages.

In connection with their ratings of securities backed by CMBS loans, rating agencies like Standard & Poor's and Moody's require that each borrower be a separate, bankruptcy-remote, single-purpose entity (SPE). In response to the ratings agency requirements, lenders include SPE covenants in their mortgage loan documents designed to minimize the risk of substantive consolidation of the borrower with its affiliates in a bankruptcy. Over time, however, these covenants have been embellished and expanded beyond the actual rating agency requirements. These extensive SPE covenants provide fertile ground for seemingly inconsequential actions to trigger full recourse liability. A borrower should be certain that its ordinary day-to-day business practices will not violate even the most trivial of those covenants (*e.g.,* separate stationery and telephone numbers for the borrower), and if they may violate certain covenants it should negotiate to delete or modify them.

The SPE covenants also frequently contain a specific covenant that the borrower will remain solvent during the term of the loan. While the borrower's solvency is an appropriate representation to be made as of the closing date of the loan, it should not be an on-going warranty. If the value of the mortgaged property declines below the aggregate outstanding amount of the indebtedness at any time, and the borrower has no other assets or operations, the borrower will inevitably become insolvent.

But decline in the value of the mortgaged property is the risk that a non-recourse lender has historically agreed to assume. How can it also trigger full recourse liability on the debt?

This is exactly what occurred in the *Cherryland* case in 2011, in which a Michigan court enforced a recourse carve out creating full personal liability for the loan as a result of the borrower's insolvency.[1] In response, the Michigan Legislature enacted a statute to the effect that a borrower's mere insolvency cannot trigger a recourse carve out. That statute had to survive constitutional challenges through to the Sixth Circuit Court of Appeals, to finally reach a result that matched commonly held industry expectations for non-recourse loans. But even the Michigan statute only protects borrowers, not guarantors. Since borrowers are single-asset entities, the guarantors bear the economic risk of a recourse carve out being triggered by insolvency.

In reviewing recourse carve out provisions, beware of cross-references to an entire section of a document, rather than to specific prohibited actions. For example, a "violation of the transfer provisions" may include a failure to give timely notice of a permitted transfer, as well as a prohibited transfer of the mortgaged property. Likewise, the "breach of any obligation under the environmental indemnity agreement" does not distinguish between the obligation to comply with environmental laws and an obligation to furnish the lender with a copy of some relevant correspondence within some specified time period.

Some recourse carve outs, such as those for "gross negligence or willful misconduct," are so vague that virtually any breach of the loan documents can be argued to constitute gross negligence or willful misconduct and trigger personal liability on that basis. Vague and imprecise terms are not likely to find an interpretation favorable to the borrower or guarantors after the loan is in default.

In a series of recent court cases around the country deciding liability under recourse carve outs, lenders' interpretations have prevailed over borrowers' more often than not. Courts frequently do not understand the rationale behind non-recourse financing or the commercial real estate industry's expectations. Repeatedly, recent court decisions have asserted that commercial borrowers and guarantors are sophisticated parties, represented by counsel, who presumably understood the loan documents and agreed to them, and should be bound by their literal terms. Those courts have strictly enforced the recourse carve out provisions of the loan documents, and when they are vague, have often interpreted them in the lender's favor.

What can borrowers and guarantors do in today's non-recourse loan market to understand and limit their potential liability?

First, a borrower should not assume there exists some standard list of recourse carve outs that every non-recourse lender subscribes to. In fact, there is now a great deal of variety in both the types of events that give rise to personal liability and the scope of those triggering events. In addition, there are differences from lender to lender regarding whether recourse events will trigger full liability for the debt or merely liability for the damages suffered by the lender.

Second, a borrower should not leave the recourse carve outs to be negotiated for the first time when drafts of loan documents are distributed. It is not unintentional that the recourse carve outs do not appear in most term sheets or commitment letters, but are merely referred to somewhat obliquely as "the standard carve outs." If they were disclosed upfront, they might overshadow the more favorable loan terms being offered, such as the interest rate or the permitted maximum loan-to-value ratio. A borrower should insist on reviewing and negotiating the recourse carve outs before it has put any money at risk in the form of deposits or escrows.

This is obviously the time in a financing transaction when a borrower has the greatest leverage. Even if the lender insists that its recourse carve outs are non-negotiable, a borrower will have the option, if after reviewing the lender's carve outs it finds them unacceptable, to shop the loan elsewhere. There may be compelling reasons to accept the recourse liability 'as-is' if the economics of the transaction are favorable enough or there are other countervailing considerations. But at least the recourse parties should understand what they are trading for seemingly favorable business terms. Once the borrower has accepted a term sheet and the deal takes on momentum, it becomes more difficult to walk away from the loan in light of the money that has been put at risk and the transaction costs that have been incurred to date.

Third, the precise wording of each recourse carve out should be carefully scrutinized. A recourse carve out for any event can be drafted narrowly or expansively. It can be vague and ambiguous, or it can identify clearly the specific actions on the part of the borrower or guarantor that will trigger personal liability. It can be stated in the passive voice so that it is not clear whose action would trigger liability, or it can be limited expressly to actions of the borrower or guarantor. The extent of the personal liability arising from a recourse carve out event can be for the lender's actual damages or for the entire indebtedness. Ideally, the extent of the liability of the recourse parties should match the magnitude of the consequences of the triggering event to the lender. If some breach can be and is cured before the collateral property suffers irreparable diminution in value, theoretically it should not trigger personal liability for the entire indebtedness.

Finally, a borrower, with the assistance of knowledgeable counsel, needs to carefully review and assess every representation and warranty and each covenant to avoid unintended or unanticipated consequences arising from seemingly immaterial breaches of their terms. For example, if the borrower is not a newly formed entity, it needs to consider whether certain representations that cover periods in the past can be made. Note that a grace period or cure right for purposes of avoiding an event of default do not necessarily prevent triggering a recourse carve out. Based on recent court decisions, a borrower should not expect that it will have either the right or the opportunity to cure a seemingly inconsequential 'technical breach' of a representation or warranty, or of a covenant that gives rise to a recourse carve out. A technical breach is an argument made by a borrower or guarantor after the fact. More often than not, it will not be the guiding legal principle by which a court decides recourse liability in the context of a commercial real estate loan. ■

Lydia C. Stefanowicz is a partner in the firm of Greenbaum, Rowe, Smith & Davis LLP.

Endnote

1. *Wells Fargo Bank, N.A. v. Cherryland Mall Limited Partnership,* 812 N. W. 2d 799 (Mich. Ct. App. 2011).