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Negotiating Non-Recourse Carveout Guaranties


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Recent court decisions should serve as a caution to borrowers and guarantors to carefully scrutinize the exceptions to the non-recourse nature of their loans. Cases challenging the enforceability of non-recourse carveout guaranties have been decided predominantly in favor of lenders—with courts expressing unwillingness to substitute their own judgment for the plain language of non-recourse carveout provisions and the judgment of the highly sophisticated parties who negotiated them.[1] These cases make clear that borrowers and guarantors cannot rely on the equitable powers of the courts to correct unintended inequities that may arise when lenders seek to enforce guaranties as written. Nonrecourse carveout guarantees were spawned by a need to deter misconduct by otherwise insulated principals of a borrower, but they have evolved into much more than that.

Last July, in *Bank of America* v. *Lightstone Holdings LLC and David Lichtenstein*, 32 Misc. 3d 1244A, 2011 N.Y. Misc. LEXIS 4412, 2011 NY Slip Op 51702U (2011), a New York court was faced with a situation where insolvent borrowers under several mezzanine loans had been forced to decide between filing voluntary petitions for bankruptcy to preserve the operations of their respective real estate assets and continuing operations without sufficient capital (or ceasing operations) at the risk of committing "waste." Under the guaranties that the borrowers were required to deliver to the lender, choosing either option would have resulted in recourse liability.

The court ruled that these two seemingly conflicting requirements were not in fact inconsistent since they were not blanket prohibitions on taking such actions but rather were mere exceptions to the non-recourse nature of a loan, exceptions that had been agreed upon by sophisticated parties. The defendants also claimed that a prohibition on filing bankruptcy should be void as a matter of public policy since the borrowers had a fiduciary duty to preserve the collateral for the benefit of their investors and lenders and that filing a voluntary bankruptcy petition was the best means to do so.[2] The court rejected this argument, noting that not only did the defendants expressly waive the right to raise such a defense in the guaranties themselves, but also that public policy favored summary judgment in favor of the lenders and enforcement of the guaranties as written. Quoting *UBS Commercial Mortgage Trust 2007-FL1* v. *Garrison Special Opportunities Fund L.P.* (Sup. Ct. NY County, Index No. 652412/2010), the court in *Lightstone* posited that the courts had no business inserting themselves in such matters: "The court is an arbiter of commercial disputes, charged with upholding freely entered into contractual arrangements in accordance with common law precedents and rules of legislative interpretation. It does not have a mandate to rewrite the rules relating to commercial and real estate finance."

Last December, in *51382 Gratiot Avenue Holdings, LLC* v. *Chesterfield Development Company, LLC* and *John Damico* v. *Morgan Stanley Mortgage Capital Holdings, LLC*, 2012 U.S. Dist. LEXIS 11617, a U.S. District Court ordered summary judgment in favor of the plaintiff lenders, finding that the borrower's covenant to not "become insolvent or fail to pay its debts and liabilities from its assets as the same shall become due" had been violated by the borrower's failure to make payments on the loan. As a result, the guarantors were held personally liable for the deficiency due on the loan following foreclosure. Less than two weeks later, in *Wells Fargo Bank, N.A.,* v. *Cherryland Mall Limited Partnership and David Schostak*, 2011 WL 6785393 (Mich. App.), a Michigan state court of appeals found that because loan documents unambiguously required the borrower to remain solvent as part of its separateness covenants, the trial court was correct in determining that the borrower's insolvency violated those covenants, resulting in the loan becoming fully recourse.

Addressing the borrower's argument that these guarantees violate public policy, the court, quoting *Woodman* v. *Kera LLC*, 486 Mich 228, 245-247; 785 NW2d 1 (2010), concluded that "[t]his case illustrates why this Court should frequently defer policy-based changes in the common law to the Legislature. When formulating public policy for this state, the Legislature possesses superior tools and means for gathering facts, data, and opinion and assessing the will of the public…The judiciary, by contrast, is designed to accomplish the discrete task of resolving disputes, typically between two parties, each in pursuit of the party's own narrow interest…."

Outlined below are some of the issues that borrowers and guarantors should consider in light of these recent decisions.

• **The failure of a borrower to remain solvent**

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or pay its debts and liabilities as they become due. As highlighted by the *Cherryland* and *Chesterfield* cases, borrowers must pay close attention to the covenants that lenders may seek to impose under the guise that they are necessary for the borrower to remain bankruptcy remote. Many of the covenants—which, if breached, may result in recourse liability under non-recourse carveout provisions—relate to matters within a borrower's control and are a reasonable and sometimes necessary means by which a lender may seek to guard against obstructive conduct by a borrower or against a borrower being substantively consolidated with a related entity in the related entity's bankruptcy.

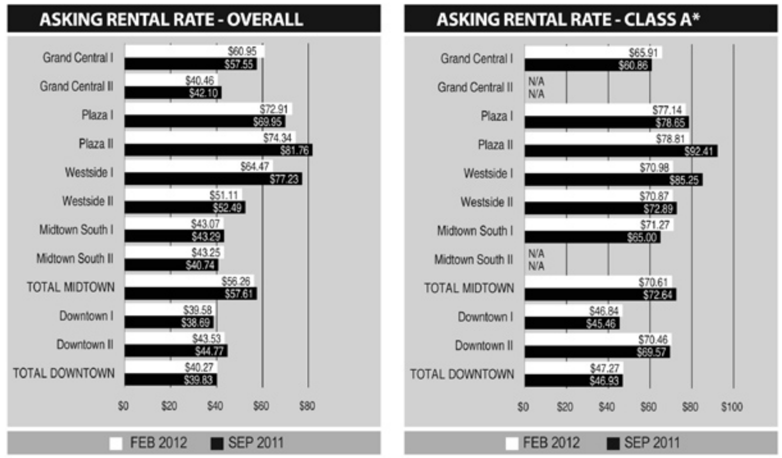
However, requiring a borrower to remain solvent and pay its debts imposes liability on the guarantor without regard to whether the borrower committed any malfeasance. In addition, insolvency itself does not place a borrower at any greater risk of being substantively consolidated into a related bankruptcy debtor.

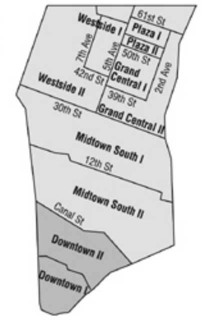
By guarantying the obligation of a borrower to remain solvent and pay its debts, a non-recourse carveout guarantor has essentially agreed to provide a payment guaranty that may be triggered by underperformance of the property, thus shifting to the borrower a lender risk that is inherent in any non-recourse loan. Moreover, a solvency covenant does not factor into agency ratings of CMBS loans—Standard & Poor's CMBS Legal and Structured Finance Criteria includes an expansive list of what it views as important borrower separateness requirements and a covenant to remain solvent is not one of them.

Borrowers should also be wary of covenants that can serve as a proxy for a prohibition on insolvency. For example, some non-recourse carveout provisions include the commission of waste as a recourse event. However, unless "waste" in this context is limited to intentional physical waste, it might be deemed to include the failure to maintain or repair the property or pay property taxes (which an insolvent borrower may not be able to do) or the retention of rents that are supposed to be paid to the lender (which is usually covered separately by a covenant prohibiting misappropriation).

Provisions which impose recourse liability for incurring prohibited debt—and which characterize as "prohibited debt" trade payables overdue beyond a specific period of time (for example, 60 days)—may also be breached by a borrower simply because it does not have sufficient cash flow to pay its expenses as they become due. Recourse carveouts relating to the failure to pay property expenses such as maintenance costs, real estate taxes and insurance premiums may, unless they are limited to situations where cash flow from the property is available to pay such expenses, cause the nonrecourse carveout guaranty to morph into a guaranty of operating deficits.

Rental Rates Per Square Foot for Manhattan Commercial Space





*Class A Buildings - Contemporary buildings with above-average rental rates and ability to compete for premier office tenants. These facilities contain state-of-the-art systems, provide exceptional accessibility and project an overall perception of high quality.

Source: Studley

• **Breaches of separateness covenants generally.** Some lenders argue that any breach of so-called "separateness covenants"—which are designed to limit the risk that the borrower will be substantively consolidated with a related party debtor—should be "springing recourse" events making the borrower and guarantor liable for the full amount of the loan, without regard for the materiality of the breach or its consequences. Some of the typical separateness covenants are as mundane as requiring the borrower to conduct its business only in its own name and use separate stationery, invoices and checks. The employees of a borrower or its management company may inadvertently commit minor technical violations of separateness covenants in ways that would not significantly increase the consolidation risk.

There are a number of possible approaches a borrower could take to reduce the risk that immaterial violations of separateness covenants will result in recourse liability. Perhaps the most favorable to a borrower is to provide that violations of the separateness covenants should be 'above the line' (i.e., limiting the guaranty to the lender's actual losses rather than springing recourse). Alternatively, borrowers may successfully argue that a violation of a separateness covenant should only trigger full recourse liability if it results in substantive consolidation of the borrower.

A third approach is to permit the borrower to cure the breach (to the extent curable) and deliver an updated nonconsolidation opinion to the lender that discloses the breaches of the separateness covenants but confirms the conclusion of the original nonconsolidation opinion. From the lender's standpoint, while the first approach may not be adequate, the latter two approaches should provide an adequate deterrent to the borrower (the potential consequences of breaching such a covenant should be sufficient to prevent a borrower from doing so intentionally) as well as an adequate remedy for the breach.

• **Non-recourse carveout covenants should be clearly defined and narrowly tailored to avoid unintended consequences.** Carveout clauses are sometimes drafted in a broad manner that could lead to unintended liabilities, and guaranties should make reference to the specific covenants in the loan documents that if violated would trigger recourse liability. In *Cherryland*, the loan documents provided that the loan would become fully recourse if the borrower "fails to maintain its status as a single purpose entity as required by, and in accordance with the terms and provisions of the mortgage" without specifically identifying the applicable covenants in the mortgage.

As discussed, remaining solvent is not a prerequisite for single-purpose-entity status; however, in deference to the plain language of the loan documents, the *Cherryland* court found that a breach of this covenant triggered recourse liability because that covenant was listed in the "single purpose entity/separateness" section of the mortgage. A springing recourse carveout that is triggered, for example, by any violation of the transfer provisions may result in full recourse liability for defaults such as failing to give notice of a permitted transfer—accordingly, the recourse parties should limit the carveout to violative transfers.

The parties should also ensure that covenants are drafted so that they do not overlap with one another. In *ING Real Estate Finance (USA) LLC* v. *Park Ave Hotel Acquisitions*, 26 Misc. 3d 1226A, 2010 N.Y. Misc. Lexis 324, the court wrestled with the question of whether a borrower's 19-day failure to pay real estate taxes that resulted in a lien against the mortgaged property was "Indebtedness" that immediately triggered full recourse or whether a separate provision applied that allowed a 30-day cure period upon the filing of a lien before recourse was triggered.

Similarly, guaranties should distinguish actions constituting misappropriation (which usually triggers recourse liability only to the extent of damages) from actions constituting impermissible transfers or assignments of mortgaged property (which may trigger full recourse); otherwise, when "mortgaged property" is defined to include cash in borrower accounts, the proper measure of liability may be unclear.

• **Recourse liability for defense of exercise of remedies.** Lenders often include a nonrecourse carveout relating to the defense of a foreclosure action, in order to prevent a borrower from deliberately frustrating a lender's ability to exercise its remedies. Although the desire to discourage borrower obstruction was one of the original justifications for the existence of non-recourse carveout guaranties and remains a valid concern of lenders, a borrower needs to preserve its right to raise legitimate defenses. Borrowers often attempt to limit recourse to defenses brought in bad faith or without a reasonable legal or factual basis, though lenders are sometimes reluctant to rely solely on a bad faith standard (which presents a high hurdle to the lender). From a borrower's standpoint, relief from the carveout cannot be predicated on the defense being successful, as that puts too much risk on the guarantor and may deter an otherwise legitimate defense.

• **Changes in control of the borrower and recourse liability.** The approach that the courts have taken in recent years suggests that they are likely to defer to the plain language of guaranties, regardless of whether the outcome was one that the parties could have originally intended. In past years, non-recourse carveout guaranties generally failed to address what happens to the guarantor's liability in a multi-lender situation once a mezzanine lender has foreclosed and taken over the upper-tier ownership interests and/or management of a borrower. While there is limited case law on the subject, the decisions cited in this article suggest that if such a mezzanine lender were to cause the mortgage borrower to take an action that triggered recourse under the non-recourse carveout guaranty given to the mortgage lender (like filing a voluntary bankruptcy), the courts would enforce the guaranty as written even though the original guarantor no longer has any economic interest in the property.

In order to prevent this result, it has now become fairly common to provide that the liability of a guarantor for the nonrecourse carveouts will not apply to violations first occurring after a mezzanine foreclosure or transfer in lieu thereof. A mortgage lender will obtain protection by requiring in an intercreditor agreement that the mezzanine lender provide an acceptable replacement guarantor in order to exercise its remedies against the mezzanine borrower.

• **Actual Damages vs. Full Recourse.** Borrowers should pay close attention to whether breaches of particular recourse covenants trigger full recourse liability or only liability to the extent of the damages suffered by the lender as a result of the breach. Certain carveouts—where damages would be difficult to assess or where deterrence of misconduct is particularly important (such as prohibitions on assignment)—may merit full recourse liability (although violations of transfer provisions are sometimes "above the line").

Recent cases have shown that courts are generally unwilling to characterize springing recourse as an unenforceable penalty even when the amount of the damages caused by the breach is easily quantifiable and far less than the amount of recourse liability that "springs" as a result. In *Blue Hills Office Park LLC* v. *J.P Morgan Chase Bank* (477 F. Supp. 2d 366), a U.S. District Court for the District of Massachusetts deferred to the plain language of a non-recourse carveout guaranty to find that a borrower's breach of a covenant not to transfer any mortgaged property resulted in liability to the guarantor for the full amount of a mortgage deficiency, which exceeded $10 million, even though the lender's damages as a result of the breach were only approximately $2 million. The borrower argued to no avail that the actual amount of the damages was known and that there were more egregious actions that the borrower could have taken that would have only triggered liability for the amount of the resulting loss.

The court in *ING* decided that full recourse liability was not a reasonable measure of the probable loss associated with minor breaches such as a delinquent payment of a relatively small amount of real estate taxes; however in that case, the court's decision rested in part on internal inconsistencies in the loan documents, and as the majority of cases have shown, borrowers and guarantors cannot depend on intervention from a judiciary that has repeatedly demonstrated its reluctance to insert itself in such matters.

1. See also New York Law Journal, March 30, 2011, "Rethinking the Bankruptcy Springing Recourse Guaranty in Multi-Lender Situations," by Meredith J. Kane, Partner at Paul, Weiss, Rifkind, Wharton & Garrison LLP.

2. Note: Some borrowers have been successful in including in their guaranties a provision stating that filing a voluntary bankruptcy petition does not result in recourse liability if the borrower can furnish to the lender an opinion of independent counsel that the directors of the borrower had a fiduciary duty to make such a filing.