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Punishing 'Bad Behavior': When Non-Recourse Becomes Full Recourse

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by Joshua Sohn and Jason Goldstein | November 20, 2013

Case Digest Summary

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Few aspects of commercial real estate finance transactions get as much attention among lenders' counsel or borrowers' counsel as the carve-outs to non-recourse loans. While lender remedies are generally limited to recourse against the mortgaged real estate, the market standard requires that an individual sponsor or other credit-worthy entity provide assurances to a lender by way of a guaranty agreement that lenders will not suffer losses by virtue of certain types of borrower or sponsor actions that fly in the face of generally held principles of good faith corporate governance and property

management. Some of these so called "carve-outs" are of a nature that result in quantifiable loss, while others so disrupt the lender's expectations and ability to enforce remedies that guarantor liability is generally of a full-recourse nature.

For example, the implication of a borrower's misapplication of insurance proceeds should be easily quantifiable while a borrower's filing of a voluntary bankruptcy can unnecessarily delay a lender's exercise of remedies. Lender enforcement of recourse carve-out guarantees has been the subject of a great deal of litigation, particularly during the past few years. This article focuses on some recent cases in New York and other states that are informative to a current understanding of the ability of lenders to enforce non-recourse carve-out guarantees.

New York Courts

Justice Shirley Werner Kornreich of the Supreme Court of New York very recently handed down an instructive ruling in *172 Madison (NY) LLC v. NMP-Group.* (http://www.newyorklawjournal.com/CaseDecisionNY.jsp?id=1202625413666) The case arose from a $29 million non-recourse loan made by UBS Real Estate Securities to NMP-Group. The loan was secured by a mortgage on a Madison Avenue property. In a carve-out guaranty, the borrower's sole member promised she would be liable for the full amount of the debt "in the event that...Borrower files a voluntary petition under the Bankruptcy code." Claiming that the borrower had defaulted on the loan, the lender sought foreclosure on the mortgaged property, as well as administrative costs. But on the day the property was scheduled for auction, the borrower filed a voluntary bankruptcy petition in the U.S. Bankruptcy Court for the Southern District of New York. As is typically the case in these scenarios, the bankruptcy filing stayed the auction.

Following the bankruptcy filing, the lender instituted an action on the guaranty and the guarantor argued that the lender was foreclosed from commencing a second action on the guaranty because New York's one-action rule precludes separate actions to foreclose and to enforce guaranties. Reviewing these facts, the court opined, "Recourse carve-out guaranties are primarily created to deal with situations such as the one that

has arisen here. In exchange for agreeing to look only to the mortgaged property in the event of default, lenders typically require that the borrower or its guarantor promise to pay the entire debt if they impede foreclosure by filing for bankruptcy." The court enforced the provision as written, noting that "the Guaranty was intended to apply to [this] exact circumstance..."

The court was not moved by the guarantor's argument that the lender could not both foreclose on the mortgage and enforce the guaranty. The guarantor argued that under New York's rule, a lender's election to foreclose a mortgage bars an independent action to collect the debt, absent leave of the court. RPAPL 1301 (3); *Rainbow Ventures v. Parc Vendome*, 221 A.D.2d 164, 164 (1st Dept. 1995). But, the court explained that the doctrine only operates "when there was a choice of remedies available at the time the prior actions were undertaken," citing *Gameways v. Dept. of Consumer Affairs*, 101 A.D.2d 888.888 (2d Dept. 1984).

In this case, the choice was created by the borrower's filing for bankruptcy, which occurred only after foreclosure proceedings had already been initiated. The court remarked, "To hold that in the context of a nonrecourse loan the election of remedies bars an action on the debt even when the springing recourse event occurred after the commencement of the foreclosure proceeding would effectively transform the lender's conditional waiver into an absolute one..." Thus the court did not bind the lender to the foreclosure remedy, and instead allowed the lender to opt for a personal money judgment against the borrower.

By contrast, in the early case of *ING Real Estate Finance (USA) v. Park Ave. Hotel Acquisition* (http://www.newyorklawjournal.com/CaseDecisionNY.jsp?id=122110), No. 601860/09 (N.Y. Sup. Ct., Justice James Yates, Feb. 24, 2010), the court refused to enforce a "Full Recourse Event" provision triggered by a late property tax payment. In *ING*, the borrower paid $300,000 in property taxes 19 days late, which caused a tax lien to be placed on the property until that tax payment was received, triggering full recourse liability for the $145 million loan, to both the borrower and guarantor. The

lender claimed that the borrower's conduct was a default under the loan documents and that the borrower and the guarantor's obligations under their non-recourse guaranties had been triggered.

The court framed the question as "whether, by the terms of the contract, the nineteen-day tardiness in paying less than $300,000 in property taxes triggers a full recourse obligation by the Guarantors." Although under a strict reading of the operative loan documents, the lender's position may be correct as a matter of contract law, the court was unwilling to find for the lender. As the court explained, "[i]mmediate liability for the entire debt is not a reasonable measure of any probable loss associated with the delinquent payment of a relatively small amount of taxes."

The court noted that enforcing the provision as plaintiff requested would make the defendants potentially liable for the entire debt of up to $145 million for just one day of delinquency on $1 in property taxes or any other debt for which a lien may be imposed. "Such an unlikely outcome could not have been intended by the parties, sophisticated commercial borrowers and lenders aided by competent counsel at the time of the drafting, and is impermissible under New York law" (citing *Truck Rent-A-Car v. Puritan Farms 2nd*, 41 NY2d 420, 425 (1977)).

The court dealt with the question of which of two conflicting provisions controlled—one allowing a 30-day notice and cure period prior to imposing full recourse on guarantor in the event of impermissible "indebtedness," such as a tax lien; or a provision allowing full recourse liability, without an express opportunity to cure, for breaches of the loan's "single purpose" covenants. The court found that the notice and cure provision "provides specific direction as to how indebtedness should be treated" and controlled over the single purpose provision that covered a "broad array of nearly twenty separately delineated covenants" and would effectively read out the notice and cure provision.

The court held that under New York law, "the terms of a guaranty are to be strictly construed in favor of a private guarantor," and therefore any inconsistency between two provisions of the credit agreement "should be resolved in favor of the Guarantors, entitling the Guarantors to a thirty-day cure period." Ultimately, the court granted the borrower and guarantor's motion to dismiss the claims seeking full recourse liability, finding: (1) guarantors were entitled to notice and cure before recourse liability could be imposed based on a lien; and (2) an outcome of full recourse on a $145 million loan based on a temporary and modest tax lien is impermissible under New York law.

Other Courts

The two New York cases discussed above illustrate the tension where a borrower is in default under its loan documents and the lender has the ability to claim that a recourse event has occurred that is sufficient to trigger full-recourse liability under a guaranty. In recent years, courts across the county, as in New York, seem to favor lenders in all but the most technical of defaults, increasingly expressing an unwillingness to substitute their own judgment for the plain language of a contract negotiated by sophisticated parties.

For example, in *Wells Fargo Bank v. Mitchell's Park* (http://scholar.google.com/scholar_case?case=4389450338725202137), 2012 WL 4899888 (N.D. Ga.), Wells Fargo's predecessor-in-interest loaned Mitchell's Park $5.5 million to build an apartment complex. The loan was structured as a typical non-recourse deal secured by a mortgage on the property. But the note included a Full Recourse Liability Clause that provided, if Borrower fails to maintain certain "single-purpose entity" requirements in Exhibit B to the Security Deed, then "Lender shall have the right to seek a personal judgment against Borrower on this Note and under any other Loan Document with respect to any and all indebtedness secured hereby." Exhibit B contained a fairly robust set of obligations, requiring that borrower: (1) "be solvent and pay its liabilities from its assets...as the same shall become due"; (2) be "a legal entity separate and distinct from any other entity...utilize a separate telephone

number and separate stationery, invoices, and checks"; (3) "establish and maintain an office through which its business shall be conducted separate and apart from those of any of its affiliates"; (4) "file its own tax returns"; and (5) "maintain adequate capital for the normal obligations reasonably foreseeable in a business of its size and character." The borrower defaulted on the note by failing to make the payments due. This was not in dispute. Rather, one of the issues at trial was whether each and every requirement in the carve-out was sufficient to trigger full recourse, thereby obligating the borrower to pay the entire loan amount. The court held that "reference to Exhibit B included all of the requirements in Exhibit B which, although they do not relate to maintaining the single purpose of operating an apartment complex, do all relate to ensuring that Mitchell's Park retained its identity while repaying the loan" (citing *Cherryland*, which is discussed infra). "Therefore, the contract should be enforced as written..."

Mitchell's Park suggests that even relatively minor "bad boy" offenses, such as failure to use separate company letterhead, can trigger full recourse liability. This is a sobering thought, and should serve as a warning to borrowers who likely cannot rely on a liquidated damages defense as a last resort. A liquidated damages defense was of no avail to the borrower in *Mitchell's Park*. The court held that the Full Recourse Liability Clause was not a liquidated damages clause because it does not fix potential damages, but rather "provides for only actual damages...the amount left on the loan at the time of the breach." *Mitchell's Park*, at 5 (quoting *Heller Financial v. Lee*, WL 1888591 (N.D. Ill. Aug. 16, 2002).

Similarly, in *Weinrib v. Fannie Mae*, 993 N.E.2d 223 (Ind. Ct. App. 2013), the court recently enforced recourse liability in the amount of $7.8 million, which included liability for the full loan amount, as well as a prepayment penalty as a result of the borrower's failure to clear mechanic's liens of approximately $72,000. The $7.8 million judgment included a prepayment premium of approximately $1.5 million. Following a sheriff's sale for approximately $6.6 million, the lender brought an action against the guarantor for the deficiency: $1.8 million. Like the guarantor in *Mitchell's Park*, the guarantor in *Weinrib* argued that he should not be held liable for the full deficiency

amount as it represents impermissible liquidated damages, especially considering the inclusion of the prepayment penalty. The court was unsympathetic to the guarantor's argument, finding that there was no ambiguity under the guaranty and that the unresolved mechanic's liens entitled the lender to hold him liable for the full amount of the indebtedness—including the prepayment premium.

Finally, one of the most talked about cases involving non-recourse carve-outs in recent years involved enforcement of a borrower's representation and covenant in the loan documents that it was, and would remain, solvent and that it would pay its debts and liabilities from its assets as they become due. In *Wells Fargo Bank v. Cherryland Mall,* (http://scholar.google.com/scholar_case?case=7702198485055228342) 295 Mich. App. 99 (Mich. Ct. App. Dec. 27, 2011), the borrower's failure to have sufficient funds in its bank account to repay its mortgage was construed by the court as "insolvency," which violated one of the SPE requirements in the loan agreement, which effectively converted a non-recourse deal into a full recourse deal. As a result, the non-recourse guarantor was found liable for the entire amount of indebtedness. Recognizing the harshness of its result, the Michigan appellate court that imposed full recourse liability on the guarantor in *Cherryland* explained that it was simply giving effect to the bargained-for terms of the loan documents and that, "[i]t is not the job of this Court to save litigants from their bad bargains or their failure to read and understand the terms of a contract."

The alarm caused by *Cherryland* and similar cases in Michigan led to the speedy enactment in 2012 of the Michigan Nonrecourse Mortgage Loan Act, which provided that post-closing solvency covenants are invalid and unenforceable. Ultimately, *Cherryland* was reversed and remanded because of the new legislation. *Wells Fargo Bank v. Cherryland Mall*, 300 Mich. App. 361 (Ct. App. 2013). But other legislatures have yet to respond to the issue in states where similar cases have arisen.

Conclusion

These carve-out cases reveal a national trend that should have commercial real-estate borrowers and lenders taking notice. Courts have adopted a strict reading of "bad boy" carve-out guaranties in non-recourse loan agreements, regardless of the perceived harshness of the result. The move seems to have been motivated, in part, by the widely held belief among judges that it is not their role to reform unambiguous contract provisions that reflect the business judgment of sophisticated parties. It appears, therefore, that courts are likely to enforce the plain language of a "bad boy" guaranty, regardless of whether the result was originally intended by the parties to the contract. Accordingly, "bad boy" guaranties must be taken seriously and their potential consequences and liability considered at the time the loan documents are negotiated and agreed to, as they can, and increasingly do, result in the imposition of material liability on non-recourse guarantors.

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