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Peer to Peer Session #3

Post-Post-Cherryland: They Meant It, Now What?
Non-recourse Loan Carve Outs

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I. Introduction

In the aftermath of an innumerable sum of 2009 Great Recession CMBS loan defaults, the results of the ensuing litigation from two cases—*Wells Fargo vs. Cherryland Mall* and *Gratiot Avenue Holdings vs. Chesterfield Development*—challenged the conventional understanding of what was considered well-settled, industry-standard nonrecourse loan carveouts. These decisions strictly held that violating post-closing solvency covenants would cause "springing-recourse" liability, in which entire nonrecourse loans would become full recourse to the borrower and any guarantors.

While the terms of CMBS loans have evolved since these decisions over the last decade, understanding nonrecourse loan carveouts are foundational for all real estate attorneys to effectively represent both borrowers and lenders. Especially as the economy continues to grapple with the consequences of the COVID-19 pandemic, the headwinds facing several sectors within the commercial real estate industry have made the current landscape of nonrecourse carveouts as relevant as ever before.

The purpose of today's workshop is (1) to provide a broad overview of the different nonrecourse carveouts being employed across the industry, and (2) to allow you all to practice negotiating key non-recourse carveout provisions amongst yourselves. First, we will start by introducing the subject and by providing the holdings of the *Cherryland* and *Chesterfield* decisions. Second, we will discuss the different types of provisions that are typically found in non-recourse loan agreements. Third, we will provide several suggestions for both borrowers and lender's counsel to negotiate these nonrecourse carveouts.

II. Overview: Defining Recourse and Non-Recourse Loans

Regardless of whether a loan is recourse or nonrecourse, a lender will only underwrite a loan if it believes that the borrower can repay the loan. Nevertheless, the basic implications of whether a borrower elects for a recourse versus a nonrecourse loan are fundamentally different.

1. What is a recourse loan?

Generally, if a loan secured by real estate is full recourse, the borrower—and typically a guarantor—is liable for the full repayment of the loan in the case of foreclosure. In other words, if a borrower defaults on a full recourse

loan, a lender can first foreclose on the property and sell the collateral real estate asset. Then, in the likely event that the foreclosure sale does not generate enough money to cover the amount of the debt owed (which is referred to as a deficiency), the lender could thereafter recover the difference between the debt and the selling price from the borrower and guarantor.

2. What is a nonrecourse loan?

Generally, if a loan secured by real estate is nonrecourse, the borrower is not personally liable to the lender in the event of a default. In other words, if a lender forecloses on and sells the property, but the sale does not generate enough money to cover the debt, the nonrecourse borrower is not liable for the deficiency (except for so-called "bad boy carveouts" which will be discussed below).

In the 1990s, the growth of the CMBS market was instrumental for establishing nonrecourse, asset specific lending. In order to offer nonrecourse loans, CMBS lenders (and other prudent lenders) require the property and the borrower to be insulated from creditors other than the lender. To achieve asset isolation, CMBS loans require the borrower to make separateness and single purpose entity ("SPE") covenants in its loan documents, which require the borrower to remain separate and distinct from its parent and its affiliates. This protects the lender's collateral from the borrower's parent's other potential creditors.

Prior to the two Michigan *Cherryland* and *Chesterfield* decisions, it was commonly understood that borrowers and guarantors would not be responsible for any deficiencies under the terms of a nonrecourse loan, unless the borrower committed a "bad boy" act, which had to be expressly stated as a nonrecourse carveout. Nevertheless, there was an understanding that for a nonrecourse loan to spring into a full recourse loan, the borrower would have to commit some *intentional* bad act (such as fraud for example). Prior to the Michigan decisions, both borrowers and lenders executed nonrecourse loan agreements with the understanding that if the borrower unintentionally failed to stay solvent and defaulted due to something outside of the borrower's control (like a recession), the borrower would not trigger a nonrecourse carveout. However, the Michigan decisions strictly interpreted a common SPE/separateness covenant regarding post-closing solvency that was present in both borrowers' loan documents. In both cases, the decisions held that the plaintiffs' unintentional defaults on nonrecourse loans would allow the lenders to foreclose on the properties, sell the collateral, and recover deficiency judgments from the nonrecourse guarantors.

3. When to use what: Aligning recourse and nonrecourse loans for differing project needs

Although exceptions are common, full recourse loans are standard for most bank, bridge, and construction loans. Recourse loans are riskier for borrowers, as borrowers are personally responsible for any deficiency that arises if the collateral is insufficient to cover the outstanding debt after a foreclosure sale. Since recourse is riskier for the borrower, borrowers typically benefit from lower interest rates and can get higher Loan-To-Value ("LTV") ratios.

Meanwhile, most Fannie Mae, Freddie Mac, and CMBS loans are typically nonrecourse. Nonrecourse loans are riskier for lenders. Therefore, nonrecourse loans on average carry a higher basis point premium over recourse loans according to a federal reserve study. Moreover, nonrecourse borrowers typically will be more experienced, and financially stronger. Similarly, while recourse loans are widely used for most asset classes, nonrecourse loans are generally reserved for low-risk properties in strong markets.

For example, while an experienced corporate owner of Class A office space in Manhattan will have a fairly easy time securing a nonrecourse CMBS loan, a first-time investor seeking to refinance a Class C multifamily property in Lincoln, Nebraska, would likely be forced to seek a recourse financing option.

III. Degrees of Recourse: Above the Line vs. Below the Line Non-Recourse Carveouts

Although triggering a nonrecourse bad boy carveout will activate some degree of recourse, recourse is best thought of along a spectrum. The extent of a guarantor's liability for a bad boy act depends on what type of carveout is triggered. Nevertheless, post-*Cherryland*, "bad boy guaranties" have become somewhat of a misnomer, since CMBS loans have expanded the definition of a recourse-triggering event to include acts that, to many borrowers and guarantors, seem *inadvertent*, *unintentional*, or are *not in any way within a borrower's control*.

There are two principal types of nonrecourse carveouts: (1) "above the line" also known as "actual loss" carveouts, and (2) "below the line" also known as "springing full recourse carveouts." For the first category of above the line or actual loss carveouts, the guarantor is liable only for any actual loss suffered by the lender as a result of the bad boy act. Meanwhile, for the second category of below the line or full recourse carveouts, the guarantor is liable for the entire amount of the debt.

A. "Above the Line" and "Actual Loss" Carveouts

For the following above the line nonrecourse carveouts, the borrower and guarantor would only be liable for the cost, loss, damage or expense incurred by the lender as a result of the borrower violating an above the line covenant. Prior to negotiating with borrowers, the form document for many lenders will a nonrecourse carveout list such as the following:

i. The willful misconduct or gross negligence of the borrower, guarantor, or any other affiliated party (referred to as the "exculpated parties");

ii. Fraud or an intentional misrepresentation by an exculpated party;

iii. Any exculpated party's misapplication or misappropriation of rents received during an event of default as defined in the loan documents;

iv. Any exculpated party's misapplication or misappropriation of tenant security deposits or advanced rents collected;

v. Any exculpated party's misapplication or misappropriation of insurance proceeds or condemnation awards;

vi. Borrower's failure to pay property taxes, insurance premiums, charges for labor or materials, or other charges that can create liens on the property;

vii. Borrower's failure to return or reimburse lender for all personal property taken from the property and not replaced with personal property of the same utility and of the same or greater value;

viii. The removal or disposal of any portion of mortgaged property after an event of default;

ix. Any exculpated party's commission of material physical waste to the property;

x. Any failure by the borrower to permit on-site inspections of the mortgaged property as required by the loan documents;

xi. Borrower's failure during the continuance of a default to deliver to the lender upon demand all rents and books and records relating to the property or comply with all written notices and instructions;

xii. Any exculpated party's criminal acts that result in the forfeiture or seizure of the property or any portion thereof;

xiii. Any failure of the borrower to appoint a new property manager on the demand of the lender's request as required by the terms of the loan documents; or

xiv. The borrowers breach of an environmental representation.

B. "Below the Line" Springing Recourse Carveouts

For the following below the line nonrecourse carveouts (also known as springing recourse carveouts), the borrower and guarantor would be liable for the entire debt or deficiency following a foreclosure. In contrast to above the line recourse events which requires "actual loss, cost, damages, or expense," below the line, springing full recourse events do not require the lender to suffer any loss resulting from the corresponding below the line covenant violation. Moreover, except as expressly stated otherwise, springing full recourse events do not require that the borrower intended to violate any of the covenants in the loan documents. Prior to negotiating with borrowers, the form document for many lenders will include a list such as the following:

i. The borrower incurs any indebtedness other than the loan made the lender and other debt as permitted in the loan agreement without the prior written consent of the lender;

ii. The borrower's failure to provide financial information to the lender as required by the mortgage and other loan documents after the lapse of all notice and cure periods;

iii. The borrower fails to comply with the SPE and separateness covenants contained in the mortgage or other loan documents;

iv. The occurrence of a prohibited transfer;

v. The property or any part thereof becomes an asset in a bankruptcy or insolvency proceeding initiated by borrower,

vi. The borrower admits, in writing or in any legal proceeding, its insolvency or inability to pay its debts as they become due;

vii. The borrower voluntarily avails itself of the benefits of any emergency law or otherwise voluntarily exercises any right or option under any emergency law and any such emergency law either (1) permits a borrower to defer or otherwise elect not to pay any amounts as and when due under any of the loan documents or (2) prevents the lender or requires the lender to forbear from exercising any rights or remedies that the lender would otherwise have available under the loan documents but for the passage of the emergency law.

viii. The borrower files an answer consenting to or otherwise acquiescing in or joining in any involuntary petition filed against it, by any other person or entity under the U.S. Bankruptcy Code or any other Federal or state bankruptcy or insolvency law, or solicits or causes to be solicited petitioning creditors for any involuntary petition from any person or entity; or

ix. The borrower consenting to or acquiescing (in writing) in or joining in an application for the appointment of a custodian, receiver, trustee, or examiner for the borrower or any portion of the property other than at the request of the lender

IV. Suggestions for Negotiating Nonrecourse Carveouts

A. Full vs. Limited Recourse

- Carefully consider whether you would like certain issues to be included as limited or full recourse. Even if a borrower's breach of a below the line springing recourse covenant causes negligible actual harm to the lender, courts will generally uphold such breaches as triggering full recourse. The lender's counsel should therefore negotiate to keep as many of the below the line clauses as full springing recourse to protect the lender's interest in the collateral, while the borrower's counsel should try to limit the recourse to actual damages.

B. SPE and Separateness Covenants

"SPE" and separateness provisions should be carefully reviewed for practical implications, including how clients operate at a property level and in their financial reporting to the lender.

i. Overbroad SPE/Separateness Covenants

- Standard lender documents often draft SPE covenants that are overbroad. For example, when representing the borrower, be on the lookout for terms that require the lender's consent for any amendments of the borrower's organizational documents (instead of amendment to the SPE provisions).

ii. Below the line vs. above the line

- While lenders will want to keep SPE covenants as below the line carveouts, borrowers have good reason to fiercely negotiate on this issue. Specifically, if kept as below the line carveouts, immaterial SPE violations (such as an employee unintentionally writing an operating expense check from the wrong checkbook), which would not materially increase the risk of consolidation, can trigger the borrower and guarantor's personal liability for the entire debt.

iii. Negotiating notice and cure periods for carveouts

- Especially given the risk of immaterial SPE violations triggering springing full recourse, borrowers should consider negotiating for a notice and cure period before recourse liability is triggered.
- Borrowers would be wise to negotiate notice and cure periods for many of the recourse carveouts, not just SPE violations (for example, transfers, to the extent immaterial and capable of being "unwound").

C. Solvency and Sufficient Capital

Cases decided in the aftermath of the great recession have generally deferred to the plain language of the loan document provisions at issue. There is continued focus today on fine-tuning carveouts that relate to solvency and do not account for insufficient revenue post-closing. See below:

i. Carveouts requiring payment of money:

- "Failure to pay taxes, insurance premiums or other charges that can create liens on the Property."
- "Waste to the Property"
- In any of the foregoing, a court strictly interpreting either of the foregoing, could find a guarantor culpable for the property's failure to generate revenue sufficient to pay taxes. A qualifier similar to below seems more inline with the intent of the parties: "failure to pay Taxes … *provided, however, there shall not be liability under this subsection unless there is sufficient cash flow generated from the Property and Borrower's access to such funds has not been restricted by Lender or any Lender agent."*

ii. Carveouts related to SPE solvency covenants:

- As discussed earlier, the special purpose entity covenants are important for lenders as a set of guidelines which, when followed, limit borrower's likelihood of consolidation with affiliates and dissolution. For example:
  - "Borrower shall maintain satisfactory capital for its reasonably foreseeable debts in a business of like size and character and business operations"
  - "Borrower shall pay its debts and liabilities (including, a fairly-allocated portion of any personnel and overhead expenses that it shares with any Affiliate) from its assets as the same shall become due."
- In both scenarios, a borrower/guarantor would wisely negotiate that either the covenant or the SPE violation carveout include a qualification similar to the following: *(to the extent that the Property has sufficient cash flow, provided, however, the foregoing solvency requirement shall not (a) require its owners or any other affiliated party to make additional capital contributions or loans to it or (b) prohibit other approved capital distributions that are acceptable under its organizational documents.)*

D. Carveouts relating to Transfers:

Similar to the practical considerations that must be made when evaluating SPE covenants, borrowers and lenders alike should examine definitions such as "Transfers", "Prohibited Transfers" and "Permitted Encumbrances" to ensure compliance. These provisions should reflect operations at the Property (such as leasing activities) and borrower's expectations with respect to equity transfers (i.e., estate planning, replacement guarantor concepts). Lender and borrower are both disincentivized from creating a foot-fault (and recourse!) for an otherwise performing loan.

E. Special considerations in light of the pandemic and future economic uncertainty

During the pandemic, anxiety levels rose for both borrowers and lenders across all asset classes. Foreclosure issues, state and federal closure mandates, and government sponsored pandemic financing all made experienced CRE professionals look again at the recourse carveouts in their various loan documents. Similar to the fallout from *Cherryland*, eyes focused on the fine points to see if there was any leverage or adjustments to be made during this period of uncertainty. As certain commercial real estate sectors continue to struggle and the economy continues to quake, it is important to think about how common recourse carveout provisions might exacerbate corresponding risks associated to borrowers and lenders. For example:

i. One typical below the line provision – "The borrower admits, in writing or in any legal proceeding, its insolvency or inability to pay its debts as they become due."
- Implication: While most stores are open following various government shutdowns, many tenants are still reeling. If a borrower reports in writing to its lender that one or more of its tenants is delayed or has defaulted in paying its rent, a lender could argue that this implies the borrower cannot pay its debt service. For your standard CMBS guaranty, this means full recourse.
- Most lenders are amenable to qualifying this carveout such that Borrower (and affiliate) communications *with lender* regarding property operations and payment of amounts due under the loan would not incur liability under the guaranty.

ii. Typical below the line provision – "The borrower incurs any indebtedness other than the loan made the lender and other debt as permitted in the loan agreement without the prior written consent of the lender."
- Usually, CMBS loans have very specific parameters around what constitutes permitted debt (i.e., debt must be unsecured, not exceed 2% of the total loan, and be incurred in the ordinary course of business for trade and operational debt). Conversely, if additional permitted debt is not defined, an anxious lender looking to pursue the guaranty rather than foreclose on a property in trouble, might ask a court to interpret this provision broadly.
- Here, the parties must try to achieve a realistic definition of the borrower and property debt that exists and may well exist in the future. PPP loans, for example, would have been (and most likely still are) expressly prohibited debt. PACE loans, although gaining more traction in the CMBS world, are still consistently prohibited at closing.
- Lenders correctly lean in hard on expanding this definition either because they are conforming to rating agency requirements or because they don't want to be in the queue with any other creditors. Borrowers should be prepared to adjust their operations to fit the lenders underwriting requirements.