

**THE LENDER'S PERSPECTIVE:
CARVE-OUTS TO NON-RECOURSE
CLAUSES IN MORTGAGE LOANS**

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INTRODUCTION

At the outset, one might ask why non-recourse loans became the norm in real estate finance in the first place. Presumably, the lender considered itself secure with the underlying asset, given some cushion against decline in value due to a loan-to-value ratio of no more than 80% or so. In reality, however, the lender in a standard nonparticipating mortgage loan has all the risk of decline in the collateral value and none of the upside potential. Even if the value of the collateral at least equals the loan amount, the lender may not get the benefit of its bargain if significant delays occur in transfer of the security after a default, during which time the lender may not be receiving any interest on the loan or income from the property. Similarly, legitimate expectations are frustrated to the extent that the property, when it does come into the lender's hands, is burdened by financial obligations which the lender must meet in order to maintain the project's viability. Examples are unpaid real estate taxes, mechanics' lien claims, environmental clean-up obligations and financial concessions to tenants which the lender never approved.

Non-recourse real estate lending nevertheless has become so standard that it is likely to continue in some form; the concept was even built into the income tax law in the form of the principle that all partners in a real estate-holding partnership--even limited partners--could include in the tax basis of their partnership interests (and thus deduct losses against) their pro rata share of non-recourse mortgage debt. What is happening in the mortgage lending community today is that lenders are becoming more diligent, thoughtful and creative in examining and addressing the most egregious abuses of the non-recourse relationship. Skirmishes between lenders and borrowers have resulted, not only in the context of new loan originations, but also in loan extensions and modifications, where "modernization" of the non-recourse provisions may be a condition to the lender's willingness to proceed.

Of course the term "non-recourse" does not now and rarely ever did mean that the borrower would under no circumstances whatsoever be exposed to personal liability beyond its interest in the collateral. Rather, non-recourse provisions typically include a number of exceptions. For purposes of this discussion, those exceptions will be called "recourse carve-outs" without distinction as to whether they give rise only to liability flowing directly from occurrence of the exception, or whether such occurrence renders the borrower fully liable for the entire loan amount.

This paper will explore four areas of lender concern in crafting non-recourse provisions and specifically, the recourse carve-outs:

- ! What is the lender constrained from doing by a non-recourse clause? What actions can and cannot be taken to collect the debt, realize on the collateral and make good any other lender losses?
- ! What are the exceptions to those general constraints, that is, the recourse carve-outs?
- ! If the circumstance contemplated by a recourse carve-out occurs, who is liable, and what assets and collateral are available to satisfy that liability?
- ! How should the liabilities arising from the recourse carve-outs be documented? Who should sign what?

WHAT THE LENDER AGREES NOT TO DO

The lead-in language to a non-recourse provision contains the lender's agreement not to sue the borrower or its general partners personally in order to reach assets not part of the loan collateral to satisfy liabilities arising under the loan.

No Deficiency Judgment

Often, this clause is written in terms of the lender's agreement not to attempt to enforce any deficiency judgment against the borrower or its general partners. Borrowers raise legitimate objections to this formulation, without more. Technically, it would permit the lender to sue the borrower personally on the note without attempting to realize on the collateral and establish a deficiency, although perhaps there are very few instances in which such conduct would be sensible. More practically, the borrower fears that the mere agreement not to pursue a

deficiency judgment would not block a lender action for damages for breach of loan document covenants and warranties.

No Personal Judgment for Money Damages

The borrower will want the clause to provide that the lender will not seek or enforce a personal money judgment for loss or damage arising from breach of the loan documents' covenants and warranties. To include this concept is perfectly consistent with the lender's expectation that the borrower and its partners will have personal exposure to the lender only under the circumstances described in the recourse carve-outs--indeed, if it were otherwise, many of the standard recourse carve-outs would make no sense as written.

Exceptions

In the non-recourse clause, the lender must take three important exceptions to the general prohibition of actions against the borrower. First, the lender must be free to name the borrower in any action necessary to enforce any lien or security interest of the lender or to realize on the security; after all, a judgment against the borrower on the note is usually essential to a foreclosure action. Second, the clause must except actions to enforce any guaranties, indemnities or other covenants which, the parties have agreed, will be full recourse obligations of the borrower.

THE RECOURSE CARVE-OUTS

Often in negotiation of recourse carve-outs the borrower will say, "But what if I had no knowledge of the condition?" or "What if I didn't cause the problem?" To understand the lender's perspective, it is helpful to focus less on culpability than on risk allocation. Examples will be highlighted throughout the discussion to follow. Conceptually, the recourse carve-outs fall into certain categories based on the lender's rationale for creating exceptions to the basic standard of "no personal liability," and each category has to do fundamentally with protecting against the risk that the lender will not get the benefit of its bargain:

- ! Protection against erosion of the value of the collateral or the priority of the mortgage lien.
- ! Protection against misrepresentation or fraud in the inducement.
- ! Protection against diversion of the collateral or its proceeds.

- ! Protection against loss of the collateral or of the lender's ability to enforce its lien.
- ! In terrorem clauses.

Erosion of the Value of the Collateral

Failure to pay real estate taxes and assessments. The lien of real estate taxes generally primes a mortgage lien. Accordingly, a foreclosing lender who must satisfy unpaid real estate taxes in order to retain the collateral has in effect paid more to obtain the property than the amount bid at the foreclosure sale. An interesting question arises in jurisdictions where real estate taxes are paid a year in arrears. There, the borrower will assert that the lender should be entitled only to hold the borrower liable for taxes payable prior to the time when the borrower turns over the property in foreclosure or by deed in lieu of foreclosure. On the other hand, the lender, taking note of the fact that local custom calls for proration of taxes on an accrual basis when property is sold, will want to be compensated for all real estate taxes accrued as of the transfer of the property; otherwise, the lender will say, if the property is sold immediately, the sale price will be diminished by the real estate tax proration credit, so in effect the value of the collateral is reduced by the entire amount of the taxes accrued, not just those which have come due.

Failure to satisfy mechanics' liens. In many jurisdictions, mechanics' liens for work or services performed subsequent to the recording of a mortgage lien can gain priority over that lien on the theory that the work or services enhanced the value of the collateral. Where this is the case, unsatisfied mechanics' liens can have exactly the same effect on the value of the lender's collateral as unpaid real estate taxes.

Waste. For many years, waste was a standard recourse carve-out which did not receive a great deal of negotiating attention from borrowers, probably due to the fact that in many states, to prove waste required a showing that the borrower had allowed the property to go to rack and ruin physically, and possibly with evil intent to boot. Recently, however, all this has changed with courts holding that failure to pay real estate taxes is actionable waste. See, e.g., *Capitol Bankers Life Ins. Co. v. Amalgamated Trust and Savings Bank*, ___ F.Supp. ___ (92 C 4480), and *Travelers Ins. Co. v. 633 Third Assocs.*, 14 F.3d 114 (2d Cir. 1994). Today's borrower thus justifiably fears that in the future, courts may further amplify the definition of waste and thus the borrower's personal exposure.

Failure to maintain and repair the property. From the lender's perspective, a recourse carve-out for failure to maintain and repair the property reflects concern that if the property is ultimately the lender's only source of satisfaction of the debt, that property needs to be turned over in at least as good a condition as when the lender underwrote the loan. Beyond the apparent simplicity of that position, however, lie myriad definitional problems. What is the standard of maintenance and repair to be? Even if the parties might agree that the property requires a certain repair, there are often many ways it can be accomplished, with vastly differing costs and durability. What if the property burns to the ground and insurance proceeds are inadequate to rebuild? Is the borrower personally liable to the lender for the deductible or self-insured amount?

Failure to perform obligations to tenants. Reflected here is the lender's concern that it may inherit a property in which the tenants have immediate claims for set-off or damages due to unperformed landlord obligations. A second area of concern arises from the prospect of leases where, unbeknownst to the lender, the borrower has taken up-front benefits, while back-ending all of the corresponding concessions to the tenant. Sometimes negotiated subordination and non-disturbance agreements with tenants will be helpful in specifying that the lender will not, upon succeeding to the landlord's position, have liability for acts or omissions of the borrower. Sometimes, too, the lender will have the right to approve or disapprove the terms of a lease, and any approval has presumably been given after taking into account the possible adverse impacts of the lease on the lender following foreclosure. Probably the appropriate focus of a recourse carve-out for obligations to tenants is (1) landlord obligations under leases which, pursuant to the loan documents, required lender's approval, and such approval was not obtained, and (2) landlord monetary obligations (whether in the form of payments to tenants or rent concessions) arising from the initial tenant improvements or other inducements to the tenant to enter into the lease, and (3) monetary obligations arising from landlord's failure to perform lease covenants required to have been performed prior to transfer of the property to the lender or a receiver.

Environmental problems. Many lenders insist on full recourse to the borrower for any environmental liability or clean-up cost, without regard to culpability or causation or even knowledge on the part of the borrower. They believe that fault is not the issue, but rather risk allocation: as between borrower and lender, whose problem should this be? Sometimes the borrower will ask for an exception for matters known to the lender at the time of loan origination. Here, the lender's response will be a function of its initial underwriting, i.e., is the property valuation on which the loan was underwritten (and thus, the loan amount derived from the required loan to value ratio) adjusted to reflect the cost to cure the

condition? Some lenders will also provide that the loan becomes fully recourse as to all amounts owing to the lender, not just the damages flowing from the environmental problem, in the event of breach of the environmental covenants and warranties. Such clauses stem from the lender's recognition that access to the collateral will not be an adequate remedy if environmental clean-up costs exceed the value of the property and the lender may decline to take the property in order to avoid exposure as a titleholder.

Transfer tax liability. Some jurisdictions impose a transfer tax applicable in the event of transfer of real property in foreclosure or by deed in lieu of foreclosure. The same risk which applies to unpaid real estate taxes--that is, diminution of the value of the collateral by the amount of the tax--may induce a lender to include a recourse carve-out for these transfer taxes.

Misrepresentation or Fraud in the Inducement

In many jurisdictions, the borrower would probably be liable for fraud on the lender, independently of what the loan documents provide and even if the loan were completely non-recourse, due to a public policy against contracting around one's own fraudulent conduct. Accordingly, negotiating attention in this area usually centers on questions of culpability; should the borrower be personally liable to the lender for damages flowing from "innocent" breaches of the many absolute representations made in the loan documents, without qualification as to the borrower's knowledge. The borrower will of course want to limit the scope of the clause to knowing and intentional misrepresentations. From the lender's viewpoint, though, to the extent that the lender has truly relied on the representations in the loan documents, the effect of a breach is the same regardless of the borrower's knowledge or intent. The lender will assert that the borrower's knowledge or degree of culpability is not the point, but rather the allocation of risk between borrower and lender as to problems with the collateral; again, as between borrower and lender, on whom should the risk fall? To the lender, the answer is obvious.

Diversion of the Collateral or Its Proceeds

Misapplication of casualty insurance or condemnation proceeds. A recourse carve-out for use of casualty or condemnation proceeds other than as expressly permitted by the loan documents has long been a relatively non-controversial feature of the non-recourse clause. Usually, the loan documents require that such proceeds be used to reconstruct the damaged property or to pay down the loan. The typical borrower's failure to protest the clause results to some extent from notions of culpable conduct and a comfort level that here, the borrower would have cash in hand to satisfy the recourse obligation to the lender.

Failure to turn over tenant security deposits. This, too, is a recourse carve-out to which borrowers seldom object, for the same reasons as with casualty and condemnation proceeds. It is hard to argue, at least at the loan negotiation stage, that a borrower should be entitled with impunity to use actual cash in hand for purposes other than those intended and leave the foreclosing lender with a corresponding liability to third parties.

Removal of personal property and fixtures. Here again, even the boldest borrower would probably concede that looting the property before turning it over to the lender should lead to dire consequences in terms of personal exposure.

Diversion of rents and proceeds. Standard non-recourse clauses have long included a recourse carve-out for rents and proceeds received by the borrower following a loan default and not used to pay expenses of the property or debt service on the loan. The clause has, however, progressively broadened in recent times, as lenders experienced the frustrating inability to get control of the property's cash flow prior to the time when the lender can obtain a receiver or other court order to protect its cash collateral. Meanwhile, the borrower may be distributing cash to its partners or, equally injurious to the lender, using the cash to amass a war chest to fund a battle that will delay still longer the lender's access to the rents. As a result, the "once burned" lender may now expand the clause to include all cash in the borrower's hands at the time of default. A good argument can also be made for reaching back to include rents received within the month or so before default, on the theory that these constitute the dollars that should have been used to make the unpaid debt service payment giving rise to the default. The Travelers case cited above dealt with a set of facts where the borrower, having failed to extract requested concessions from the lender, defaulted on the loan and on a real estate tax payment and promptly thereafter distributed \$17 million in cash reserves to its partners. Notwithstanding what were apparently fully non-recourse loan documents, the Second Circuit held that Travelers was entitled to equitable relief for the waste arising from the borrower's failure to pay real estate

taxes. This case underscores the importance of the recourse carve-out at issue; it took two appeals to the Second Circuit to get the lender a shot at forcing the real estate tax payment, while the borrower's partners stood to walk away with about \$13 million even after paying the tax bill.

Loss of the Collateral or the Lender's Ability to Realize

Environmental problems. As discussed above, lenders will sometimes provide that the loan becomes fully recourse should the borrower breach the environmental covenants and warranties, on the theory that in such circumstances, the lender may choose not to take title to the contaminated property in order to avoid risks possibly exceeding loss of the collateral for the loan.

ERISA violations. In loan transactions between parties who may be subject to the Employee Retirement Income Security Act of 1974, the borrower's violation of the ERISA representations and covenants in the loan documents may give rise to full recourse. This recourse carve-out addresses the concern that if the loan transaction or the lender's attempt to enforce its remedies for breach should be characterized as a prohibited transaction under ERISA, the lender might lose the entire collateral for the loan.

In Terrorem Clauses

Violation of due-on-transfer clause. If the borrower violates the loan document prohibitions against sale of the property or of interests in the borrower, the non-recourse clause is sometimes lifted due to the lender's view that central to its bargain is the identity and capability of the party in control of the collateral. Further, to avoid liability is entirely within the borrower's control; it need only abide by its covenant not to engage in prohibited transfers.

Violation of prohibition against secondary financing. Here, the lender's concern focuses on the fact that junior financing is very often recourse, so that the borrower will have an incentive to service the second at the expense of the non-recourse first mortgage. Again, the argument goes that the borrower risks exposure only if it does what it has expressly agreed not to do in the loan documents. In this case as well as the recourse carve-out for violation of the due-on-sale clause, the borrower may legitimately argue that the clause should apply only to voluntary transfers or encumbrances.

Contest of lender enforcement proceedings. Recourse carve-outs more and more commonly include a provision to the effect that the loan will become fully recourse if the borrower contests the lender's foreclosure or other proceedings to

enforce its rights to the collateral. The borrower will immediately cry foul, protesting that it is unfair to require, in effect, that the borrower waive its right to raise defenses which may be perfectly valid. The lender, for its part, will assert that at the heart of the bargain for a non-recourse loan is the assumption that there will be full and timely access to the collateral to satisfy the debt. The lender will also point out that it is the rare lender who brings an enforcement action for default other than failure to make a payment, whether of debt service, real estate taxes or insurance premiums. Payment defaults are by their nature objective and the facts easily established, and the borrower will have no defense except payment in full of the obligation. Indeed, the lender could probably agree, without much difficulty, to except the defense of payment in full from the operation of this recourse carve-out. It should be noted that the enforceability of a clause lifting the non-recourse agreement if the borrower contests enforcement is not free from question to the extent that (1) a court construes the clause as a waiver of the borrower's right to assert a defense, and (2) the defense in question is not waivable under local law (e.g., usury in certain jurisdictions).

Resort to bankruptcy protection. One of the most controversial recourse carve-outs in common use today is the clause negating the non-recourse covenant if the borrower files for bankruptcy protection. The popularity of the clause grew in the recent real estate recession, where single asset borrowers with properties valued well below the first mortgage balance nevertheless sought to avoid (or perhaps more realistically, delay) the loss of the property in foreclosure by filing for reorganization under Chapter 11 of the Bankruptcy Code. The popular wisdom among lenders today is that those borrowers got their motivation from the prospect of forestalling loss of the property and its cash flow and perhaps also attendant adverse tax consequences, rather than from a sincere belief that the borrower could successfully reorganize. As in the case of the "no contest" recourse carve-out, it is not entirely certain that the "no bankruptcy" clause is enforceable. If construed as a waiver of the right to file for bankruptcy protection, such a clause would of course be covered by the ipso facto prohibition of the Bankruptcy Code. Note, however, that by analogy to recent cases upholding waiver of the right to object to lifting of the automatic stay given in the context of a workout agreement (see, e.g., In re Cheeks, 167 B.R. 817 (Bkrtcy. D.S.C. 1994), a recourse carve-out for bankruptcy filing could have improved chances of enforceability if agreed to in the context of a loan modification. From the standpoint of enforceability, it is also important to note that the borrower is not waiving the right to file, but rather agreeing that adverse consequences will flow from a filing. Here, the identity of the party having recourse may become important. Such a provision is often set up as a guaranty by principals of the borrower that either (1) "springs" into effect on the borrower's bankruptcy filing, or (2) is presently effective but subject to release if and when the lender gets title

to the collateral following a default without an intervening bankruptcy filing. The use of a guaranty would appear to make the prospect of ipso facto characterization more remote, since the adverse impact arising from the filing technically falls on a party other than the one availing itself of bankruptcy protection.

WHO IS LIABLE UNDER THE RECOURSE CARVE-OUTS?

Often lender and borrower devote large amounts of time and attention to crafting the recourse carve-outs and very little to the question of who will stand behind the liabilities created. For the lender, well negotiated and drafted recourse carve-out clauses will mean next to nothing if the only party liable, should the clauses be invoked, is a partnership borrower with no assets other than the collateral, having a single-purpose corporate general partner with minimal capitalization and no assets other than its partnership interest. Ideally, the lender will bargain for a guarantor of recourse carve-out liabilities who has assets separate and apart from an interest in the property. A prudent lender may also require collateralization of the guarantor's liability at the time of loan origination; when a loan default occurs, the guarantor may also be in financial difficulties, and thus the fraudulent transfer risk will be greater than at the time the loan was funded. If no guarantor of the recourse carve-outs is in the picture, the borrower can save the breath and energy that would have otherwise gone into resisting the recourse carve-outs.

DOCUMENTING THE RECOURSE CARVE-OUTS

As noted above, the non-recourse clause must clearly identify the parties having liability for the recourse carve-outs, and those parties must evidence their obligations by signing the loan documents. It should go without saying that notwithstanding borrower's and lender's agreement that certain principals of the borrower will be liable, the lender will have an uphill battle enforcing that agreement without a signed writing from the parties against whom the lender wants to assert liability. If principals of the borrower are to stand as guarantors of the recourse carve-outs, they should execute either a separate guarantee or a joinder to the note indicating that they are joining in and executing the note for the purpose of acknowledging their joint and several liability with the borrower for the payment and performance of the recourse liabilities.

The borrower typically wants to repeat the non-recourse provision in each of the loan documents. While this practice is not objectionable to the lender, it is cumbersome and probably unnecessary so long as the provision is included in the note and makes reference to its applicability to all of the covenants in each of the

loan documents. The attached form clause illustrates many of the recourse carve-outs discussed in this paper.

Finally, a word about the loan application and commitment. Silence in these documents as to the non-recourse nature of the loan will likely be construed in support of an argument that the obligations were intended to be fully recourse. By the same token, it is essential that the lender cover in detail the recourse carve-outs to be included in the loan documents at the time of the application or commitment in order to avoid any adverse construction as to the parties' intent.

**SAMPLE NON-RECOURSE CLAUSE
WITH CARVE-OUTS**

Section ____ . Limitation of Liability. Subject to the limitations and exceptions contained in this Section ____, Lender shall look solely to the Mortgaged Property for payment of any principal, interest or other amounts which may become due and payable under the Note, and no other property of Borrower or any partner of Borrower shall be subject to levy, execution or enforcement for the satisfaction of Lender's remedies under the Note; provided, however, that the foregoing provisions of this Section ____ shall not (i) limit or impair in any way the validity or priority of the lien of the Mortgage or the liens created under any other Loan Documents, (ii) prevent the failure to pay when due of any amounts under the Loan Documents, or the failure to comply with any other covenants under the Loan Documents, from constituting a default under the Loan Documents, (iii) limit or impair in any way Lender's right to cause a foreclosure sale or other enforcement of its remedies as to the Mortgaged Property under the Loan Documents, (iv) limit or impair in any way Lender's right to name Borrower a party defendant in any action for foreclosure under, or other enforcement of, the Loan Documents, if Borrower is a necessary party in connection therewith, (v) limit or impair in any way Lender's rights, or release any person's or entity's obligations, under [any indemnity or guaranty given in connection with the Loan], or (vi) limit, impair or constitute a waiver by Lender of any rights to damages, other monetary relief, or any other remedy at law or in equity, against Borrower, its partners or any other party liable under any of the Loan Documents, by reason of or in connection with any of the following:

- (a) Fraud or material misrepresentation in connection with the Loan;
- (b) Any breach of the obligations of Borrower under [the environmental provisions] of the Mortgage, including, without limitation, the indemnification obligations thereunder;
- (c) Waste or any act or omission by Borrower which materially reduces the value of the Mortgaged Property;
- (d) The failure following a default under any of the Loan Documents (retroactive to the date of the default in question) to apply all of the rents (however styled or termed), issues, profits or other income from the Mortgaged Property or other collateral or security provided under any of the Loan Documents to the payment of the Indebtedness, after paying all reasonable, ordinary and customary expenses directly incurred and currently due for the operation of the Mortgaged Property;

(e) The collection of rents (however styled or termed) or other income from the Mortgaged Property or other collateral or security provided under any of the Loan Documents more than thirty (30) days in advance or the failure to account for security deposits of tenants or other occupants at the Mortgaged Property (and interest required by law or agreement to be paid thereon) which in either such case are not turned over to Lender immediately after Lender's demand following the occurrence of a default under any of the Loan Documents;

(f) The application of insurance proceeds or condemnation awards relating to the Mortgaged Property or other collateral or security provided under any of the Loan Documents in a manner contrary to the applicable provisions of the Loan Documents;

(g) The failure to maintain casualty and liability insurance as required under the Loan Documents;

(h) The occurrence of any Prohibited Transfer without the prior written consent of Lender;

(i) The voluntary encumbrance of the Mortgaged Property or any part thereof or interest therein by a lien securing an obligation for which Borrower or any of its partners are personally liable;

(j) The existence of any Lien on the Mortgaged Property (whether or not voluntary) other than those liens which are Permitted Exceptions;

(k) The removal, in violation of the Loan Documents, of any fixtures or personal property now or hereafter constituting collateral for the payment of Borrower's obligations under the Loan Documents;

(l) The filing by or against Borrower of any (i) voluntary bankruptcy or insolvency proceeding or (ii) involuntary bankruptcy or insolvency proceeding which is not dismissed within ninety (90) days of filing;

(m) Any act by Borrower or its partners to contest, delay or otherwise hinder Lender's enforcement actions, whether to obtain appointment of a receiver, foreclose the Mortgage or take any other action to enforce its rights or remedies;

(n) The failure to pay real estate taxes, special assessments, personal property taxes and other levies or assessments constituting a lien against all or any

part of the Mortgaged Property or other collateral or security provided under any of the Loan Documents;

(o) Any seizure or forfeiture of the Mortgaged Property or other collateral or security provided under any of the Loan Documents, or any portion thereof or the Lender's interest therein, pursuant to federal, state or local laws;

(p) Any breach by Borrower of [the ERISA provisions] of the Mortgage, including, without limitation, the indemnification obligations thereunder;

(q) Any sums required to be expended by Lender to perform landlord obligations under leases of the Mortgaged Property required to have been performed prior to any transfer of possession of the Mortgaged Property to Lender or a receiver;

(r) Any modifications, terminations or cancellations of leases of the Mortgaged Property without the Lender's prior written consent, if and to the extent such consent is required under the Loan Documents.

If any of the circumstances described in Subsections (a), (h), (i), (l), (m), (o) or (p) of this Section ___ shall occur, then Lender's agreement not to pursue personal liability as set forth above shall be **NULL AND VOID**, and, in such event, Borrower, its general partners and any other party liable under the Loan Documents shall be personally liable for payment of the Indebtedness and performance of all other obligations of Borrower under the Loan Documents.