

Real Estate *Update*

Nonrecourse Loans

Are 'Carveouts' Overwhelming Lending?

The growth of real estate development in the 1980s coincided with the rise of the “nonrecourse loan,” whereby the lender gave up its right to sue the borrower personally upon default, confining itself to recourse against the collateral property. Lenders’ losses in the real estate recession of the early 1990s, attributable at least in part to such nonrecourse lending and the growth of the securitized loan market in the late 1990s, drove lenders to chip away at the nonrecourse nature of the loans and increase the number of so-called “nonrecourse carveouts.”

The list of carveouts has grown so long that the very essence of nonrecourse loans has been called into question. Furthermore, since key principals of borrowers now enjoy greater protection from liability in the commonly used limited liability company structure than was previously available in the limited partnership context, many lenders require the principals to deliver guaranties of the nonrecourse carveouts both as an incentive to cause such guarantor to ensure responsible operations of the property as well as to give the lender easier access to a “warm body.”

Whether this increase in potential liability has or will lead to better lender protection in practice is an open question as there is little certainty how such carveouts are likely to be treated by today’s courts.

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Old-Style Provisions

All else being equal, nonrecourse loans pose greater risks for lenders than full recourse loans. Even though lenders can rely on an equity cushion in the collateral to soften downside risks, market risks that diminish the value of the property beyond the borrower’s initial equity investment will be incurred by

a lender in a nonrecourse loan back to the borrower.

A typical nonrecourse provision from the 1980s and early 1990s, before the current influx of additional carveouts, may have read, in part, as follows:

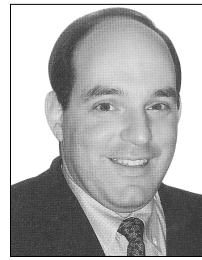
Nothing in this Mortgage shall (a) limit the right of the Mortgagee to name the Mortgagor as a party defendant in any action or suit for foreclosure under this Mortgage so long as no judgment in the nature of a personal monetary judgment shall be enforced against the Mortgagor or any of the Mortgagor’s partners, officers, directors, shareholders or principals, (b) constitute a waiver of any right of the Mortgagee as against the Mortgagor for obligations or liabilities incurred by the Mortgagee or imposed against the Mortgaged Property as a result of asbestos or any other hazardous substances which are now or may hereafter be present on or within the Mortgaged Property, (c) in any way impair Mortgagee’s right to bring an action for fraud or misrepresentation on the part of Mortgagor, or (d) in any way impair Mortgagee’s right to collect any and all rents, issues, profits and income deriving from the Mortgaged Property which have been applied by Mortgagor from and after the occurrence of a default hereunder to items other than the payment of the Debt hereunder, or actual costs incurred in connection with the maintenance of the Mortgaged Property.

This nonrecourse provision (including the limited exceptions to nonrecourse) seem simple by today’s standards. The provisions did not specify whether recourse triggered by the carveout was limited to actual damages or

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the lender in a nonrecourse loan. Perhaps concerned that the nonrecourse nature of the debt and lack of borrower accountability could decrease the motivations of borrowers to act in a way that best protects the lender’s collateral, lenders introduced exceptions to the nonrecourse nature of the loans being made.

At first limited to those actions widely accepted as inherently wrongful, such as fraud and misrepresentation, the current list of recourse carveouts has grown to include more economic and tangential wrongdoings, such as borrowers’ failure to pay real estate taxes, carry insurance or pay service providers regardless of available cash flow. The net result of such new carveouts is to shift some of the economic risks usually incurred by

whether the whole loan became fully recourse, though presumably borrowers expected that recourse was limited to actual loss or damages. Additional uncertainty arose from the fact that few courts addressed how such carveouts could be enforced. The few courts that decided cases involving borrower actions or inactions that decreased the value of the collateral property construed nonrecourse carveouts broadly in favor of lenders.

'Credit Lyonnais'

One example of lender-favored construction of nonrecourse provisions was *Credit Lyonnais v. Getty Square Associates*, 876 F. Supp. 517, 521 (S.D.N.Y. 1995).

In *Credit Lyonnais*, the Second Circuit held that the general partner of a borrowing entity could be held personally liable for misappropriated rent collected after the borrower defaulted even though the nonrecourse clause specifically shielded the general partner from liability. Because a carveout stated that nonrecourse provisions would not apply in the case of a breach of trust, the court allowed the lender recourse against the general partner. It also held that the lender could seek satisfaction against the general partner personally without demonstrating the partnership's insolvency because the general partner's breach of trust rendered him personally liable for rents collected following default.

Although the holding in *Credit Lyonnais* indicated that courts sought to protect lenders, those banks making nonrecourse loans suffered significant losses in the early 1990s. In response, many of those events previously designated simply as "Defaults" or "Events of Default" were transferred to the list of events or occurrences that trigger recourse against the borrower, changing the risk allocation between borrower and lender. Therefore, borrower actions or inactions that previously would have only offered the mortgagee standard mortgage remedies against the property now trigger recourse against the borrower and, in many cases, personal liability for key principals who are required to deliver guaranties of the borrower's nonrecourse obligations.

CMBS

Lender losses were not the only reasons for dramatic changes in carveout provisions. The rise of the commercial mortgage-backed securities (CMBS) market had a

substantial impact on both the types of nonrecourse carveouts included in today's mortgage documents as well as the manner in which lenders secure payment of such potential obligations.

CMBS originators pool mortgages in a fashion that allows investors to buy and sell mortgages in a way similar to how investors purchase corporate bonds, thereby increasing liquidity in the mortgage market.

There are three elements of the CMBS market that have driven the creation and inclusion of additional carveouts.

The first is the need to eliminate potential interruptions of cash flow to the CMBS investors. In response, CMBS lenders often require borrowers to cause all receipts from the property to be deposited into a lockbox account controlled by the lender. The corresponding carveout covers losses resulting from the borrower's misapplication of such receipts. The collection of rents in a lockbox together with the applicable carveout allow lenders to recover in case the property is not properly handled by the borrower.

Secondly, the CMBS market relies on the fact that all information regarding the borrowers and the property be disclosed to investors for evaluation. Investors require financial statements and property inspections in order to monitor CMBS securities. Thus, separate carveouts have arisen to address potential borrower failures to provide financial statements and failures to permit property inspections. Borrower failures to disclose can serve to make CMBS securities less desirable to investors.

Finally, CMBS loans require complex corporate structuring to meet rating agency standards. In order for rating agencies to properly evaluate the loans involved in the CMBS market, CMBS lenders now uniformly require borrowers to form a special purpose entity (SPE) to own and operate the mortgaged property. The importance of the SPE structure has led to the third type of new carveouts.

Special Purpose Entity

An SPE is a single asset, single purpose entity which maintains its status by making regular disclosures, maintaining certain corporate formalities that prove it to be an independent entity, and by limiting its debt load. CMBS lenders require borrowing entities to maintain SPE status for a number of reasons. First, since each borrower's sole asset

is the mortgaged property, there is no need to underwrite borrowers' other assets and liabilities. Second, because an SPE is limited in purpose and in assets, it limits the number of potential creditors if the borrower files for bankruptcy.

The single-asset limitation on the SPE has the additional effect of limiting the lenders' available recourse against the borrowing entity. Recourse against the SPE itself would have limited returns because the SPE's sole asset is the mortgaged property. While personal guaranties of the nonrecourse carveouts are sometimes required in conventional loan settings to encourage principals to mind the operation of the collateral property, CMBS lenders dealing exclusively with SPEs nearly always require borrowers' principals to guaranty performance of the carveouts in order to make the principal's assets available in the case that borrowers violate a carveout.

The number of carveouts is not the only difference between present and past carveout provisions. Lenders now group certain carveouts as triggers for recourse of actual loss, cost, or damage, or alternatively as triggers for "full springing" or "exploding" recourse. Carveouts that trigger full recourse are usually related to borrowers' "bad acts." Thus, in certain situations, borrowers may be liable for the entire loan, not simply the lost value or damages.

The following selected provisions detail those events that subject the borrower to recourse for actual loss, cost or damage incurred by lender:

- (i) the gross negligence or willful misconduct by or on behalf of the borrower in connection with the Loan;
- (ii) wrongful removal or destruction of any portion of the property after an Event of Default;
- (iii) any intentional, physical waste of the property resulting from the action or inaction of borrower;
- (iv) any legal requirement resulting in the forfeiture by borrower of the property, or any portion thereof, because of the conduct or purported conduct of criminal activity by borrower;
- (v) the misapplication or conversion by or on behalf of the borrower of (A) any insurance proceeds, (B) any awards received in connection with a condemnation (C) any gross revenues (including rents or security deposits);
- (vi) failure to pay charges for labor or materials or other charges that can create liens on any portion of the property;
- (vii) the failure to pay taxes;
- (viii) failure to

obtain and maintain the fully paid for insurance policies.

Also present in today's nonrecourse carveouts (at least in the context of loans securitized in the CMBS market) are the following provisions which trigger full recourse against the borrower and any Guarantor Carveout:

The Obligations shall be fully recourse to Borrower in the event that: (i) the first full monthly payment due under the Note is not paid when due; (ii) Borrower fails to provide financial information, fails to maintain its status as a single purpose entity or fails to appoint a new property manager upon the request of Lender, each as required by, and in accordance with the terms and provisions of, this Agreement; (iii) Borrower fails to obtain Lender's prior consent to any subordinate financing or other voluntary Lien encumbering the Property; (iv) Borrower fails to obtain Lender's prior consent to any Transfer of the Property or any interest therein or any Transfer of any interest in Borrower, in either case as required by this Agreement; (v) Borrower, or any Guarantor files a voluntary petition under the Bankruptcy Code or any other Federal or state bankruptcy or insolvency law; or (vi) if any Guarantor (or any person comprising Guarantor), Borrower or any affiliate of any of the foregoing, in connection with any enforcement action or exercise or assertion of any right or remedy by or on behalf of Lender under or in connection with the Guaranty, the Note, the Mortgage or any other Loan Document, seeks a defense, judicial intervention or injunctive or other equitable relief of any kind, or asserts in a pleading filed in connection with a judicial proceeding any defense against Lender or any right in connection with any security for the Loan.

One particular carveout that raises concern about enforceability is a "full springing" recourse carveout triggered if the borrower "contests" foreclosure or any other remedy available to the lender to enforce the terms of the loan documents. Most documents provide that a "contest" can consist of interposing any counterclaim or defense, regardless of its merit. In New York, the absolute right to equitable redemption cannot be waived at the inception of a mortgage, so courts may not

allow what substantively amounts to the same type of waiver to trigger full recourse against the borrower.

Perhaps it is understandable then why there are so few decisions regarding the enforceability of nonrecourse carveouts since

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lenders have effectively paralyzed borrowers who may wish to contest the enforcement of any of the carveouts; keep in mind that, as written in most cases, the contest exception does not differentiate between whether the borrower has rightfully contested the lender's enforcement or not.

Bankruptcies

Bankruptcy poses additional questions about the enforceability of nonrecourse carveout provisions in much the same vein as the contest provision. In each instance, lenders fear that the law may not allow lenders to place constraints on borrowers' legal rights. However, in *First Nationwide Bank v. Brookhaven Realty Assocs.*, 223 A.D.2d 618 (1996), the mortgage loan documents contained an exception to nonrecourse if a bankruptcy proceeding was commenced by or against the borrower and that proceeding was not dismissed or resolved within 90 days of its filing in such a way that permitted the bank to exercise its security interest in the property.

The borrower in *First Nationwide Bank* contended that §365(e) of the Bankruptcy Code prevents automatic contract modifications in executory contracts based on debtor bankruptcy. The Appellate Division, Second Department, held that §365 was inapplicable because mortgages are not executory contracts and therefore, statutory bankruptcy restraints against ipso facto clauses in executory contracts would not apply. Also, the court stated that it was able to make such a decision because after dismissal of the bankruptcy proceeding, the issue concerning the carveout

was a question of state law, not bankruptcy law. The court therefore avoided making a decision on lender's rights while the bankruptcy proceeding is open.

The decision of *Heller Financial, Inc. v. Lee*, 2002 U.S. Dist. LEXIS 15183, is the most recent indication of how courts will treat certain loss, cost, or damage nonrecourse carve-outs.

The borrowers in *Heller Financial* were two partners in a limited partnership that purchased a hotel. The financed portion of the purchase price was secured by the partnership's equity interest in the property. The loan contained an exception to nonrecourse in which the co-signing borrowers would become fully liable for the actual damages if the borrowers allowed liens placed on the hotel property without the lender's consent. When such liens were placed on the property and went uncontested, the lender held a foreclosure sale of the equity interest and sought the unpaid balance of the note from the borrowers because the borrowers failed to prevent or contest the liens.

The court rejected borrowers' argument that the carve-outs created excessive liquidated damages and were therefore unenforceable penalties. This portion of the decision may indicate a future hesitation of the courts to enforce liability exceptions that allow for liability in excess of actual damages.

Although the transaction litigated in *Heller Financial* was structured as an equity pledge and not a mortgage, the court does not distinguish its holding as applying solely to equity pledges as opposed to mortgages and presumably, the case applies to nonrecourse carveouts in general.

Conclusion

Nonrecourse loans have become limited recourse loans. Due to lenders' losses in the early 1990s and the emergence of CMBS markets, nonrecourse carveout provisions have grown.

Although borrowers and lenders are uncertain about court enforcement of many carveouts, particularly regarding borrower rights to contest foreclosure and file bankruptcy, borrower may continue to be loathe to bring cost challenges to carveouts, given the dire consequences if their challenge is unsuccessful.