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'Bad-Boy' Guaranty Gets a Surprising Interpretation

N.J. courts have expanded the liability of guarantors under nonrecourse carve-out guaranties

By Russell Bershad

Nonrecourse carve-out guaranties are personal guaranties issued in connection with mortgage loans where the lender's recourse for repayment is limited to the mortgaged real estate. Nonrecourse carve-out guaranties are used in connection with commercial mortgage-backed securitized loans, commonly referred to as CMBS loans. They are also a prominent feature of Freddie Mac and Fannie Mae multifamily loans, loans made by life companies and by many other nonbank lenders.

The nonrecourse carve-out guaranty provides the lender with recourse to an entity or a warm body with assets, who will be liable to the lender for certain acts or violations of the loan documents. However, unlike a payment guaranty, a nonrecourse carve-out guaranty does not impose liability on the guarantor for nonpayment of the loan by the borrower.

Nonrecourse carve-out guaranties originally may have been triggered by bad acts of the borrower, and so have been called "bad-boy" guaranties. However, the list of acts and events that trigger the guarantor's liability has expanded substantially beyond acts that might be considered to constitute bad conduct on the borrower's part. Not only have the guaranties been drafted to include more triggering events, but courts have expanded the liability of guarantors under nonrecourse carve-out guaranties.

New Jersey is one of many states where courts have interpreted a nonrecourse carve-out guaranty in a manner that might be considered surprising (see the *Princeton Park* case, discussed below). Perhaps the most notorious decision has come from Michigan in the infamous *Cherryland* case, which led the Michigan legislature to adopt a curative statute which, in a decision released in April, withstood legal challenges on a remand of the original *Cherryland* decision.

Before discussing the cases, let us take a look at the typical composition of a nonrecourse carve-out, or bad-boy, guaranty. The guaranties are similar but not uniform.

Every carve-out guaranty is triggered by a voluntary bankruptcy filing by the borrower. Most include involuntary bankruptcy filings in which the borrower colluded in some fashion.

Other triggers may include: fraud; intentional misrepresentation; misapplication of tenant rents after a loan default; misapplication of tenant security deposits, insurance or condemnation proceeds; failure to pay real estate taxes and insurance premiums; allowing liens to encumber the mortgaged property; impermissible transfers of title to the mortgaged property or change in ownership of the borrowing entity; violation of environmental indemnities; waste; failure to comply with financial reporting requirements; failure of borrower to maintain its status as a special purpose, bankruptcy remote entity (an SPE) and comply with SPE covenants; and interference with lender's efforts to foreclose after an event of default or maturity.

One of the most important features

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of a nonrecourse carve-out guaranty is the scope of the guarantor's liability. Liability is divided into two baskets. For many acts, the guarantor indemnifies the lender against all losses, damages, etc., arising from the forbidden acts. For others, the guarantor becomes liable for the full debt regardless of the actual loss caused by the borrower's acts or violations. Obviously, this is a crucial distinction and can be the subject of more negotiation than the list of triggering acts.

Full recourse always results from a bankruptcy filing by the borrower. As a result, bankruptcy filings in nonrecourse loans with bad-boy guaranties have diminished materially. Other full recourse triggers vary among lenders but often include violating the prohibition on encumbering the property, violating the due on sale/change in ownership prohibitions, fraud, interference with lender's enforcement actions after an event of default or maturity and violation of the SPE covenants.

Princeton Park and *Cherryland*

Against this background, we review the decision of the New Jersey Appellate Division in *CSFB 2001-CP-4 Princeton Park Corporate Ctr. v. SB Rental I*, 410 N.J. Super. 114 (App. Div. 2009), and the decision of the Michigan Court of Appeals in *Cherryland*.

In *Princeton Park*, a $13.3 million nonrecourse mortgage loan was made to SB Rental in 2001, with a nonrecourse carve-out guaranty from principals of the borrower. In 2004, the borrower borrowed $400,000 from another lender, secured by a second mortgage on the property, in violation of the original mortgage loan covenants against additional encumbrances. The second mortgage loan was paid off in seven months. In 2006, the borrower defaulted on the first mortgage. After the lender foreclosed, it brought an action against the nonrecourse carve-out guarantors to collect on a $5 million deficiency, on the basis that the guarantor became liable for the full loan as a result of the second mortgage, which was made in violation of the prohibitions in the first mortgage.

The trial court entered summary judgment in favor of the lender against the guarantors, which was upheld by the Appellate Division. Here are the relevant loan terms:

> Note Provision: Notwithstanding anything to the contrary in this Note or any of the Loan Documents ... (B) the Debt shall be fully recourse to Maker in the event that ... (iii) Maker fails to obtain Payee's prior written consent to any subordinate financing or other voluntary lien encumbering the Mortgaged Property.
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> Guaranty Provision: Notwithstanding anything to the contrary in any of the Loan Documents ... (ii) Guarantor shall be liable for the full amount of the Debt in the event that ... (C) Borrower fails to obtain Lender's prior written consent to any subordinate financing or other voluntary lien encumbering the Mortgaged Property.

The Appellate Division rejected the argument that the nonrecourse carve-out constituted an unenforceable liquidated damages provision, stating, "Non-recourse carve-out clauses like the one here are not considered liquidated damages provisions because they operate principally to define the terms and conditions of personal liability, and not to affix probable damages." The court also rejected the contention that the carve-out should not apply since the second mortgage was satisfied and caused no damage to the first mortgagee. In this regard, the court wrote, "Having freely and knowingly negotiated for the benefit of avoiding recourse liability generally, and agreeing to the burden of full recourse liability in certain specified circumstances, defendants may not now escape the consequences of their bargain."

Princeton Park is one of several dozen decisions, nationally, strictly enforcing nonrecourse carve-out guaranties against guarantors. It is likely that no case in this area has received more attention than *Cherryland*. *Wells Fargo Bank v. Cherryland Mall*, 812 N.W.2d 799 (Mich. Ct.App. 2011), superseded by statute, 2012 PA 67, Mich. Comp. Laws 445,1591 (2012), as recognized in 820 N.W.2d 901 (Mich. 2012), and remanded to 2013 Mich. App. LEXIS 651 (Mich.Ct.App. 2013).

In 2002, Cherryland obtained a nonrecourse mortgage loan for $8.7 million, with a nonrecourse carve-out guaranty from principals of the borrower. The loan went into default, was foreclosed in 2010, and there was a $2.1 million deficiency.

The note holder then sued the guarantor and borrower to collect the deficiency. The trial court concluded, and the Court of Appeals affirmed, that the borrower's failure to remain solvent violated the covenant to maintain its status as a single-purpose entity and triggered the full recourse provision of the mortgage. The loan documents provided that the loan would become full-recourse if the borrower failed to maintain its status as a single-purpose entity as required by the mortgage. The mortgage included a representation and covenant that:

> (f) Mortgagor is and will remain solvent and Mortgagor will pay its debts and liabilities (including, as applicable, shared personnel and overhead expenses) from its assets as the same shall become due.

The Court of Appeals observed:

> We recognize that our interpretation seems incongruent with the perceived nature of a nonrecourse debt and are cognizant of the amici's arguments and calculations that, if accurate, indicate economic disaster for the business community in Michigan if this Court upholds the trial Court's interpretation. Nevertheless, the documents at issue appear to be fairly standardized nationwide, and defendants elected to take that risk—as did many other businesses in Michigan and nationwide. It 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 court then concluded:

> In summary, based on the rules of contract interpretation and the persuasive authority of decisions of other Courts that have interpreted nearly identical loan documents, we

agree with the trial court that the mortgage, as incorporated into the note, unambiguously required Cherryland to remain solvent in order to maintain its SPE status. Having admittedly become insolvent, Cherryland violated the SPE requirements, resulting in the loan becoming fully recourse.

Cherryland provoked a swift legislative response, resulting in the adoption of the Michigan Nonrecourse Mortgage Loan Act, 2012 PA 67, MCL 445, 1591 et seq. (NMLA), effective March 29, 2012. The NMLA applies to all nonrecourse loan documents then in existence or thereafter entered into. It provides that a post-closing solvency covenant is invalid and unenforceable. On remand, the NMLA was challenged on constitutional and other grounds. Based on the NMLA, the court concluded that the guaranty provisions are invalid and unenforceable.

Lessons

After the original *Cherryland* decision, the response of many attorneys representing borrowers and guarantors in nonrecourse loans has been to negotiate to try to remove post-closing solvency covenants from loan documents. Because the covenant has the effect of converting a nonrecourse loan into a recourse loan, it is a reasonable request.

New Jersey does not have an equivalent to the NMLA. Even if we did have a similar statute, it would only address one of several covenants and provisions triggering full-recourse liability in nonrecourse carve-out guaranties. In light of *Princeton Park*, and cases around the country such as the original *Cherryland* decision, there is no reason to anticipate that our courts will not strictly construe nonrecourse carve-out guaranties as written. Lenders' and borrowers' counsel will continue negotiating the list of carve-outs and the scope of liability. As noted earlier, whether a violation triggers recourse for the full debt or is limited to the loss suffered by the lender is a critical issue. After all, if recourse in *Princeton Park* had been limited to the loss suffered by the lender, it is likely that the guarantor would have had no exposure, as it is hard to imagine that a second mortgage, which was only on the property a short time and was paid off long before the loan went into default, caused any actual loss to the first mortgage holder.■