Nasty Surprise - The "Springing Recourse Obligation"

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Imagine the expression of surprise and dismay on the face of a "limited" guarantor who receives a lender's demand for payment of the loan *in full*. This scenario is not unusual but totally unexpected.

The SPE. A single-purpose entity (SPE) is simply a company whose business purposes are restricted to the ownership, operation, maintenance and sale of one piece of real property. In general terms the SPE is disqualified from maintaining a Chapter 11 proceeding which could adversely affect the rights of the lender to foreclose or insist on performance of the loan agreement according to its negotiated terms. This gives the lender some additional protection and confidence that his rights will be respected by the courts without change. In exchange for the borrower's agreement to conduct itself as an SPE, lenders often reduce the scope of liability of both the borrower and the guarantors.

General Liability of Makers and Guarantors. Unless otherwise agreed, the maker / borrower of a promissory note is fully liable on the promissory note and indebtedness arising under the loan documents. Therefore, the borrower must repay the note from both the assets which are provided as collateral upon which a lien is asserted as well as the borrower's other assets and credit, unless otherwise agreed by the lender. A lender may grant "non-recourse" status to the borrower and promise that the borrower would not be liable for any part of the indebtedness such that the borrower's other assets remain unencumbered and no judgment can be entered against the borrower for any shortfall on the note. The same is true for those who guarantee the payment and performance of the borrower's obligations to the lender.

A broad non-recourse provision is not uncommon but the more common situation is to grant limited non-recourse status to the borrower and those people who guarantee the borrower's performance of the loan. Limited non-recourse is generally expressed as "carve-outs" or "springing recourse obligations" (SROs).

"Carve-Outs" are a specific list of items for which the non-recourse liability collapses and the borrower and guarantor are liable, typically: real property taxes, tenant security deposits, underfunding of escrows for insurance and reserves and other cash items which the lender reasonably expects will flow with the property back to the lender in the event that the security is reacquired or upon default such that the lender is in the same position it should have been had the loan been performed but for the nonpayment of the debt itself. Generally, each of the carve-outs is a discreet liability such that restoration of the amount of money related to it is the limit of liability.

An SRO means that upon the mere occurrence of a certain event, with or without actual harm to the lender, the borrower and its guarantors will be liable for the full amount necessary to satisfy the loan obligations in their entirety, not only for the amount needed to restore a specific fiscal item. Full recourse liability of the borrower and guarantors automatically springs from the occurrence of the prohibited bad act or event. *Caveat:* lenders have been known to treat carve-outs in the same manner as SROs; additionally, the breach of a carve-out provision may trigger "springing escrows" to provide immediate deposits and funding as security for those items.

"Bad boy" acts as part of the SRO exceptions often include: (a) the failure of the borrower to maintain its existence as an SPE; (b) amendment of the SPE organizational documents to permit other businesses; (c) failure to maintain separate corporate existence; (e) acquisition of additional properties; (f) incurring of additional debt; (g) violation of operating covenants, e.g. making distributions, intercompany loans or other insider transactionsor failing to maintain specific financial ratios; and (g) insolvency of the SPE.

There are two typesof insolvency: the balance sheet test or the equitable insolvency doctrine. If assets exceed liabilities, the company is solvent in the sense of a balance sheet test, but even if so, the illiquidity of the company may preclude it from maintaining current payments on its obligations which is "equitable insolvency." Loan documents are often unclear as to which type of insolvency disqualifies the SPE or whether either of them would do so. Consider that the very decline in real property value of the asset held by an SPE may precipitate balance-sheet insolvency while the failure to make the mortgage payment may be sufficient to invoke equitable insolvency as an event of default and SRO.

Insolvency of the SPE, whether equitable or in the balance sheet sense, can disqualify the SPE, even though the only default in the SPE's current obligations is the failure to make payments under the loan itself. Borrowers and guarantors have argued that default in the payment of the loan was not intended to be included within the definition of equitable insolvency. They further object to finding balance sheet insolvency as a basis for SROs where the declining value of the collateral is the sole reason for negative net worth or failure to meet financial ratios. They argue that the essence of non-recourse provisions is to require the lender to look only to the collateral for recovery upon default where the borrower has not committed any wrong. This argument fails.

If the language of the SRO provision is not ambiguous and provides no express exception for the loan itself as excluded from consideration in applying a test of insolvency, default in the loan payments alone will be sufficient to spring full recourse liability on the guarantors even if the SPE is current on all of its other obligations and its assets exceed its liabilities.

Surprise. The borrower is generally not surprised at the invocation of carve-out liability or SROs because it is the borrower's own conduct which has caused the problem. On the other hand, guarantors are often surprised. At the inception of the loan, the guarantors expected that their exposure would be nominal because they expected that the SPE was properly set up and would be operated correctly. Thus, the guarantor who is not closely involved in the operations of the project, a "remote guarantor," may wake up one day to a demand from the lender declaring that not only may funds be due under the carve-outs but also that the non-recourse provisions of the limited guarantee have collapsed and that the guarantor is now fully responsible for the entire amount of the loan.

Moreover, once the SRO has collapsed and the guarantor's liability springs into full bloom, the root of the problem is exposed: the inevitable lawsuit on the guarantee. When either the carve-outs or the SRO provisions spring into play, they permit the lender to declare default under the loan and guaranties and seek judgments against theborrowers and guarantors directly, often without the necessity of foreclosure or liquidating the collateral as a precondition to obtaining a judgment. Lenders will often sue on the notes and guarantees and place a receiver in control of the collateral long before initiating foreclosure. Of course the judgment must be credited by the amount realized from the foreclosure sale of the property.

Expectations. Borrowers and guarantors, rightly or wrongly, have assumed that as long as the SPE was properly qualified and that no carve-outs or obvious bad boy provisions were egregiously violated, a default under the loan documents would not trigger their unlimited liability. They were rudely surprised when collateral values declined and lenders sought avenues of recovery on the "road less traveled."

Courts have made it clear that, unless the language of the loan documents is ambiguous, contracts will be enforced according to their terms and that there will be no argument that the intention of the borrower did not include SROs. The mere fact that the borrower has one interpretation and the lender another does not make the language ambiguous. In general, the risk of ambiguity lies upon the drafter of the loan documents, usually the lender. This is why a co-drafting position, stating that the parties and their counsel have jointly drafted the documents, and that no presumption shall arise by virtue of the authorship of any particular provision, is often inserted into loan agreements, in order to avoid the operation of the foregoing rule.[1]

Conclusions. Borrowers and guarantors under existing loans should carefully review their loan documents and the status of their operations since the inception of the loan in order to avoid unintended violations, cure them, or resolve such matters before the lender declares default and the SROs are invoked. Loan documents in new financings should be carefully scrutinized not only for the precise language of the SPE and SRO provisions but also for their potential consequences, whether intended or unintended. SB

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Endnotes

[1]The following cases illustrate these issues and the arguments made by borrowers, guarantors and lenders:*51382 Gratiot Avenue Holdings v. Chesterfield Development Company v. Morgan Stanley Mortgage Capital Holdings*, 835 F. Supp. 384 (E.D. Mich. 2011) (mortgagor's failure to make payments on loan where nonpayment of the mortgage itself was deemed to create insolvency in violation of the nonrecourse provisions of the loan resulting in springing full recourse); *Wells Fargo Bank, N.A. v. Mitchell's Park, LLC*, 2012 WL 4899888 (N.D. Georgia 2012) (failure to maintain separateness of single purpose entity as well as failure to pay property manager and Wells Fargo as the obligations of payment became due were sufficient to collapse the insulation of borrower and guarantors and trigger the full recourse liability clause; *Blue Hills Office Park, LLC v. J.P. Morgan Chase Bank*, 477 F. Supp. 2nd 366 (D. Mass. 2007) (transfer of property triggered full recourse); *LaSalle Bank, N.A. v. Mobile Hotel Properties, LLC*, 367 F. Supp. 2nd 1022 (E.D. La. 2004) (amendment of articles of incorporation violated single purpose entity requirements triggering full recourse liability); *First Nationwide Bank v. Brookhaven Realty Associates*, 637 NYS 2nd 418 (N.Y. App. Div. 1996) (full recourse liability upon occurrence of borrower's bankruptcy not dismissed within 90 days); *Wells Fargo Bank, N.A. v. Cherryland Mall Limited Partnership*, 812 N.W.2d 799 (Mich. App. 2011) (violation of solvency covenant triggered full recourse to mortgagor and guarantor. *See also* David A. Jaffe, *Bankruptcy Remote Financings in Jeopardy After Michigan Appellate Court Decision*, Banking & Financial Services Pol'y Rep., Sept. 2012 at 12; Stephen D. Lerner, *Recent Bankruptcy and Financial Restructuring Law: Looking to 2013, Banking and Financial Restructuring Law 2013* WL 574481 at 20, 22 ("*Cherryland* and *Chesterfield* should serve as a wakeup call to guarantors and their counsel that it is time to redraft complicated and potentially ambiguous carve-out provisions so they are clear and concise. It must be clear that not only does the borrower have to be insolvent to trigger guarantor liability, but also the guarantor must be the cause of the insolvency.... As for those representing lenders, this may be a new avenue to explore, given the increased size of foreclosure deficiencies in this depressed real estate market....").