Non-Recourse Debt

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When homeowners acquire their residence and enter into a mortgage, the lender in real estate transactions has what is known as a recourse loan. The loan is secured by the signatures of the buyers and collateralized by the real property acquired. If a bank should, at some point in the future, be required to foreclose because of the non-payment of the obligation, the bank has, in New York what is known as "an election of remedies". This election allows a bank to sue on the note or to sue on the mortgage. Suing on the mortgage means a foreclosure action. Suing on the note means pursuing a client's liquid assets, such as bank accounts, securities brokerage accounts and other money equivalents. If after a foreclosure action the proceeds of sale do not satisfy the indebtedness, the borrowers remain liable for the deficiency.

Realtors are not often given an opportunity to be involved in non-recourse mortgages. A non-recourse mortgage is a mortgage indebtedness secured by the pledge of the real property but for which the borrower is not personally liable. If the borrower defaults, the lender can foreclose but the lender's recovery is limited to the collateral. Such loans are sometimes issued in commercial transactions. In the current environment, it has become more and more difficult to obtain a non-recourse loan. Nevertheless, Realtors should be familiar with the nuances of non-recourse debt, particularly when engaging in a commercial or investment property transaction.

Why Are Non-Recourse Loans Relevant?

Recent court decisions have been surprisingly harsh to guarantors who have provided limited guaranties of what was believed to be non-recourse debt. If a Realtor has become the owner of commercial real estate as an investment or is part of a partnership which has executed a non-recourse mortgage, there are nuances which recent court cases have brought to light which require awareness and diligence.

Non-Recourse Carve-Out Guaranties

In virtually all non-recourse loan documents, banks and other lenders provide that if certain occurrences take place, the entity which borrowed the money will become liable for the losses incurred by the lender. Similarly, the principals who are the owners of the borrowing entity, can become personally liable as well. Most lenders offering non-recourse loans require that the borrower's principals personally guaranty payment of the lender's losses under what are known as non-recourse carve-outs. These are memorialized at the closing by "non-recourse carve-out guaranties".

In past years, many company principals signed non-recourse carve-out guaranties, believing that the likelihood of personal liability was remote. Such carve-out guaranties are applicable against a principal of a limited liability company or corporation when:

1. There is a misapplication of insurance proceeds, a condemnation award or a security deposit;
2. There is a failure by the borrower to pay real estate taxes or special assessments;
3. There is a violation of environmental covenants;
4. The borrower commits waste;
5. The borrower or the borrower's guarantors make fraudulent misrepresentations or fail to disclose material facts to the lender.

Once a principal has signed the partial-recourse carve-out guaranty, the guarantor's liability is limited to the losses and damages suffered by the lender as a result of the event.

Full Recourse Carve-Outs

In other instances, a guarantor who does not carefully read and analyze a non-recourse carve-out guaranty can become liable for the entire amount of the loan in the most unexpected circumstances. Many lenders include provisions which give them full recourse to the individual principal's personal assets if the borrower sells or transfers the mortgaged property without the lender's prior consent, or the borrower files a voluntary bankruptcy or the borrower merges with another entity which is engaged in a separate activity or the ownership of another parcel of property. Typical full recourse carve-outs occur when a borrower:

1. Incurs additional indebtedness;
2. Amends its organizational documents;
3. Merges with another entity;
4. Acquires assets other than the mortgaged property;
5. Comingles assets with the assets of another entity; or
6. Engages in a business other than the ownership and operation of the mortgaged property.

How Do Courts Construe Non-Recourse Carve-Out Guaranties?

The past four years have resulted in numerous difficulties for borrowers and operators of real estate. In many instances, borrowers obtained loans that were readily available and secured by excellent parcels of property that were fully or almost fully occupied. When a landlord obtained a tenant such as Linens and Things, Bombay Shops, The Sharper Image or other national enterprises which have now ceased retail operations, landlords thought they were assured of sufficient cash flow to amortize mortgage loans. As many landlords have now lost what appeared to be superb tenants, cash flow has been impaired and landlords have had to scramble for funds to fulfill continuing obligations. In a recent New Jersey case (CSFB 2001-CP-4 Princeton Park Corporate Center LLC v. SB Rental I, LLC) the Court ruled that not only the borrower but the borrower's guarantors became personally liable for the balance of a substantial loan under the following circumstances: The lender made a $13.3 million mortgage loan to the borrower. The principals of the limited liability company borrowing the funds signed non-recourse carve-out guaranties. Those guaranties made the loan fully recourse to the borrower and to the guarantors if the borrower obtained subordinate mortgage financing without the lender's prior written consent. The borrower needed a short term loan and obtained a subordinate mortgage for $400,000. The lender's consent was not sought and seven (7) months later, the borrower paid off the $400,000 loan. Less than two (2) years later, the borrower defaulted on the original $13.3 million loan. The lender foreclosed and sought a deficiency judgment against the borrower and the individual owners of the entity in the amount of $5.2 million.

The borrower and the guarantors did not dispute the fact that they had technically violated the non-recourse carve-out guaranty but argued that it would be unjust and unfair to hold them personally liable for the loan balance because any default was cured and did not harm the lender. As has typically been the position taken by the Courts in similar cases, the Court determined that non-recourse carve-out provisions are valid and enforceable. Whether or not the default was cured or actually caused any harm to the lender is irrelevant. The Court concluded:

> **"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, (the borrower and guarantors) may not now escape the consequences of their bargain."**

Ohio Case

In an Ohio case, 111 Debt Acquisition LLC v. Six Ventures Ltd., the borrower borrowed $20.9 million. The principals of the borrower executed non-recourse carve-out guaranties which indicated that the lender would have full recourse against the guarantors if the guarantors consented to a bankruptcy. Circumstances changed and the borrower ultimately filed for bankruptcy. The guarantors indicated to the Court that they should not be held personally liable because the bankruptcy filing was dismissed and one of the guarantors did not consent to the bankruptcy. Once again, the Court rigidly enforced the non-recourse carve-out guaranties by indicating that the fact that the bankruptcy was dismissed was irrelevant. The fact that one guarantor did not approve of the bankruptcy filing was irrelevant. The Court concluded that having agreed to be personally liable for damages if there was a breach of the loan documents upon bankruptcy, all of the personal guarantors had rendered themselves fully liable to the lender.

New York Case

In a recent New York case (Bank of America v. Lightstone Holdings LLC and David Lichtenstein (32 misc. 3rd 1244A, 2011)), the borrower and the borrower's principal were faced with insolvency. When they looked at the non-recourse carve-out guaranties that had been given at the closing of the loan in favor of Bank of America, they noted that the non-recourse nature of the loan would not apply if there was a voluntary bankruptcy petition filed or if the borrower committed "waste". Waste occurs when a property cannot be properly cared for. In this instance, the borrower had insufficient cash flow to sustain the operations of the company's real estate assets or to avoid the deterioration of the property.

After much consideration, the borrower chose to file a bankruptcy petition and when Bank of America sought to enforce the non-recourse carve-out guaranty, the borrower and the guarantor defended by indicating that a prohibition against filing a bankruptcy petition should be against public policy because the borrower had a fiduciary duty to preserve the collateral for the benefit of their investors and for the benefit of Bank of America.

Once again, the Court rejected the arguments of the personal guarantors. Not only did the forms of guaranty executed by the principals expressly waive the right to raise such a defense, the Court said that Bank of America should be given summary judgment and full enforcement of the guaranties as written. The Court quoted a prior case decided in New York County in 2010 (UBS Commercial Mortgage Trust 2007-FL1 v. Garrison Special Opportunities Fund L.P.) in which the Court stated:

> **"The Court is an arbiter of commercial disputes charged with upholding freely entered into contractual arrangements in accordance with common law precedents and rules of legislative interpretation. It does not have a mandate to rewrite the rules relating to commercial and real estate finance."**

Louisiana Case

In the harshest case of all, LaSalle Bank v. Mobile Hotel Properties LLC, the guarantors of a non-recourse liability were held fully liable to LaSalle Bank because the limited liability company filed an innocuous amendment to its articles of organization. When the guarantors showed the Court that the single purpose entity which owned the real property had amended its articles of organization in such a way that it had no effect upon the lender, the Court responded by indicating that:

> **"The mortgage means what it says."**

When the borrower amended its articles of organization without the prior written consent of the lender, it triggered the full recourse liability for itself and the loan guarantors.

Conclusion

Realtors engaged in commercial transactions and Realtors who own commercial real estate should be particularly cautious in the current environment if they believe that they are involved in a transaction in which a mortgage loan has been represented to be "non-recourse". Without looking at the non-recourse carve-out provisions carefully, borrowers and their principals may be far more vulnerable than they possibly imagine. If you have invested as part of an investment group in a commercial property thinking that there is no recourse to you in the event of a default by the borrowing entity, you are encouraged to carefully review the non-recourse carve-out provisions in the loan documents and take appropriate steps to ensure yourself that neither you nor the borrower violates the provisions of the non-recourse carve-out guaranty.

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