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'Bad boy' Guarantees May be Triggered by Insolvency

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An appellate court has concluded recently that language used in many nonrecourse commercial real estate loan agreements triggers full recourse liability whenever the borrower becomes insolvent. Because guarantees are only called upon when a borrower is insolvent, this holding threatens to transform many nonrecourse loans into de facto full recourse loans and to upend the relationships between commercial real estate lenders and borrowers.


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THE RISE OF NON-RECOURSE LENDING

Most modern commercial real estate loans are now made on a nonrecourse basis by which the lender agrees that if the borrower defaults the lender's sole remedy is to foreclose and take back the property. The essential bargain between lender and borrower is that the lender agrees not to pursue recourse liability directly or indirectly against the borrower or its owners, provided that the lender can comfortably rely on the assurance that the financed asset will be "ring-fenced" from all other endeavors, creditors and liens related to the parent of the property owner or affiliates, and from the performance of any asset owned by such parent entity or affiliates. It is not just the isolation of the real property asset, but the isolation of the cash flows coming from the operation of the real property, from which debt service is paid on the mortgage loan and is subsequently distributed to the holders of securities backed by such mortgages.

The lender thereby accepts the risk of a borrower's insolvency, inability to pay or lack of adequate capital after the loan is made. Typically, the lender requires that the borrower be a single purpose entity created to own and manage the one commercial property. This structure prevents the borrower from commingling assets which might reduce its ability to repay the loan and isolates the lender's security from other creditors.

For its part, the borrower also agrees not to engage in "bad boy" conduct, such as making misrepresentations in connection with obtaining the loan, misapplying the rental payments, transferring or encumbering the property securing the loan, filing for bankruptcy, or other deliberate and intentional activities that would threaten the lender's security or interfere with its ability to enforce its collateral.

To help ensure that the borrower does not misbehave, the lender requires a creditworthy guarantor (usual a principal or managing member of the borrower) to provide a guaranty of the borrower's liability. If the borrower engaged in any "bad boy" activities, generally understood to be intentional and deliberate acts, the guarantor would become personally liable for the full amount of the unpaid loan.

A recent appellate court decision from Michigan turns this recourse loan structure on its head.

THE *CHERRYLAND* DECISION

In *Wells Fargo, N.A. v. Cherryland Mall Limited Partnership*, the owner of Cherryland Mall in Traverse City, Michigan, received an $8.7 million nonrecourse mortgage loan. One of the covenants in the loan agreement, which appears as standard language in many loan agreements, was that the borrower would not "fail to remain solvent or pay its own liabilities." A guaranty from a Cherryland principal provided that the loan became fully recourse if the borrower violated any of the "bad boy" covenants.

Because of the economic downturn, the borrower defaulted and became insolvent. Following a foreclosure, there was a deficiency of $2.1 million. Wells Fargo sued the borrower and guarantor, arguing that the guarantor was liable for the deficiency because the borrower breached the covenant requiring it to remain solvent and pay its debts as they became due. The trial court agreed and entered a judgment for the full amount of the deficiency against the guarantor.

On appeal, the guarantor argued that the parties did not intend to make the loan fully recourse as to the guarantor unless the borrower became insolvent as a result of its intentional or willful bad acts. He noted that Cherryland's inability to make its loan payments did not result from any willful or intentional "bad act." The guarantor also warned that allowing the loan to become fully recourse simply because the borrower was insolvent was against public policy and

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could lead to "economic disaster for the business community."

The appellate court rejected these arguments. The court stated that is must "give effect to every word, phrase, and clause in a contract and avoid an interpretation which would render any part of the contract surplusage or nugatory." The loan documents did not specify that full recourse liability would be imposed only as a result of the borrower's intentional or deliberate act. Instead, the documents stated, "any failure to remain solvent, no matter what the cause, is a violation" of the loan covenants. The court dryly observed that "[i]t 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."

Chapter 40T is a response to a flood of affordable housing expirations expected to occur in the next five years.

The court did acknowledge that its construction of the covenant "seems incongruent with the perceived nature of a nonrecourse debt" but rejected the guarantor's public policy argument as well, holding that it was up to the Michigan legislature to address matters of public policy.

The case has been appealed further to the Michigan Supreme Court.

CONCLUSION

The potential impact of the *Cherryland* decision, if upheld on further appeal and adopted by other jurisdictions, is immense. Because most of these loans are part of a commercial mortgage-backed securities pool, very little can likely be done now to amend the language of individual agreements. Nevertheless, lenders, borrowers, and guarantors should review their agreements to determine if they are at risk. For any new loans, borrowers and their counsel need to review any covenants carefully to ensure that they are drafted narrowly to avoid such unintended results.

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