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Recent Decisions on Non-Recourse Carve-Outs in CMBS Loans

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Recent court decisions in the state of Michigan—*Wells Fargo Bank, NA v. Cherryland Mall*, ____ N.W.2d _____, 2011 WL 6785393 (Mich.App. 2011) (*Cherryland*) in the Michigan intermediate appellate court and *51382 Gratiot Avenue Holdings Inc. v. Chesterfield Development Company*, 2011 U.S. Dist. LEXIS 142404 (E.D. Mi. Dec. 12, 2011) (*Chesterfield*) in a federal district court—have presented lenders, master and special servicers with new considerations in enforcing their rights and remedies, but confronted borrowers and guarantors in real estate finance markets with vastly different legal liability and unexpected economic consequences than had previously been understood or thought to have been documented in CMBS mortgage transactions. In CMBS loans, "non-recourse" means recourse solely to the property and cash flow unless there are losses occasioned by the borrower's "bad boy acts" for which the borrower and guarantor would be liable and in certain limited events—such as property transfer/subordinate financing, voluntary or collusive involuntary bankruptcy filing and failure to maintain SPE status (no other debt, no other property and no other business covenants)—for which borrower and guarantor would have full recourse liability for the entire debt.

Cherryland

In *Cherryland*, the borrower entered into a non-recourse CMBS loan with an individual as the non-recourse, carve-out guarantor. Seven years later, the cash flow from the property could not support the debt and the borrower defaulted. After the foreclosure, the lender then sued the guarantor, claiming that the borrower's insolvency constituted a failure "to maintain its SPE [. . .] status" and, as a result, the loan was fully recourse to the guarantor (and he was responsible for the deficiency). The mortgage had a section entitled "Single Purpose Entity/Separateness," including a solvency provision. None of the subsections ever used the words "single purpose entity" (SPE) or identified which provisions were SPE and which were separateness covenants. The guaranty provided that the guarantor was fully liable if the borrower failed to maintain its status as an SPE. While the trial judge excluded extrinsic evidence and stated that solvency was an SPE provision on appeal to the Michigan Court of Appeals, the court held that extrinsic evidence should be admitted to define what "single purpose entity" means in the context of the non-recourse carve-out for failure to maintain SPE status. Quoting the S&P U.S, CMBS Legal and Structured Finance Criteria and the CREFC/MBA amicus brief ("GGP Amicus Brief") in the General Growth Properties (GGP), bankruptcy (which used the defined term "Separateness Covenants" for both SPE and Separateness Covenants), the court concluded that separateness is a component part of

SPE, such that maintaining SPE status requires abiding by the separateness covenants. The court disregarded contrary evidence, (including S&P publications, the mortgage loan purchase agreement and testimony of the intentions of the parties) that maintaining SPE status does not require continued solvency and that the loan was non-recourse in the event of the borrower's insolvency without actual bad boy acts.

Chesterfield

Chesterfield also involved a non-recourse loan to an SPE borrower with an individual as the carve-out guaranty guarantor. The documents provided for recourse to the borrower and guarantor if the borrower "fails to comply with any provision of Section 4.2 of the Security Agreement," which incorporates the Separateness Covenants excluded in *Cherryland* and specifically provides that the borrower will not "become insolvent or fail to pay its debts and liabilities *from its assets* as the same shall become due (*emphasis added)*." The court held that the borrower's "failure to make the monthly payments did in fact trigger . . . (borrower's and guarantor's) . . . full recourse liability" for the full amount of the debt (even without an occurrence of bad boy acts).

GGP Amicus Brief

Prior to the rulings in *Cherryland* and *Chesterfield*, the GGP Amicus Brief discussed in detail that SPE covenants were developed to avoid entity bankruptcy, while separateness covenants were developed to avoid substantive consolidation in the bankruptcy of an affiliate. If every insolvency of a borrower causes the borrower and guarantor to be liable for the whole debt, there is no entity separateness—the cash flow of the property has not been successfully isolated and therefore subjects the borrower to possible substantive consolidation in the bankruptcy of an affiliate or parent entity. It may also render every non-consolidation opinion issued or accepted with respect to similar documents of questionable value. Moreover, springing full recourse liability for a bankruptcy filing in CMBS loan documents would be meaningless as every insolvency would cause full recourse for the debt, and therefore, the borrower would have no disincentive to file for (or to collude to file an involuntary) bankruptcy.

As the GGP Amicus Brief states:

> The bedrock element of CMBS financing is the isolation of the asset to be financed. This is the essential bargain between borrower and lender that permits financing on a non-recourse basis: 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 assets owned by such parent entity or affiliates. More specifically, 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 subsequently distributed to the holders of the securities issued backed by such mortgages.

Loan Documents

Unfortunately, these two cases represent another example of the problems with CMBS 1.0 (and probably CMBS 2.0) loan documents failing to properly put into "words" what the intention and understanding of borrowers and lenders (as well as rating agencies) is regarding the essential bargain between borrower and lender. In non-recourse financing the lender agrees not to pursue recourse liability directly or indirectly against the

borrower or its owners (or its guarantor), 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 assets owned by such parent entity or affiliates. More specifically, 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 subsequently distributed to the holders of the securities issued backed by such mortgages.

Conclusion

The courts in these Michigan cases did not properly consider the language in the context of the critical architecture for CMBS that lenders and borrowers (as well as rating agencies) intended, believed they had agreed to in the CMBS loan documents, and relied on in CMBS mortgage financings. As the GGP Amicus Brief concludes:

> Protecting the integrity of such uninterrupted cash flow is the *sine qua non* of CMBS. It is not an exaggeration to say that if a CMBS lender cannot get comfortable with the isolation of the real property asset to be financed and hence the cash flows derived from the operation of such asset, then no such financing will occur.

The attorney general of Michigan and CREFC have filed motions with the Supreme Court of Michigan for leave to file their briefs as amicus curiae together with their respective amicus curiae briefs in the appeal of *Cherryland*.

Cherryland and *Chesterfield* stand for the proposition that insolvency is always an SPE requirement (*Cherryland*) and a borrower's failure to pay the debt triggers full recourse for the borrower and guarantor under the CMBS loan documents without the occurrence of any bad boy act by the borrower (*Chesterfield*). In future CMBS loan financings, borrowers and guarantors, as well as lenders, will need to review their CMBS 2.0 loan documents with great care and negotiate the language to best protect their position, or at least make crystal clear the intent and purpose of the insolvency SPE requirement.

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