Real Estate Finance & Investment ADVISORY

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The Impact of *Cherryland* and *Chesterfield* on New CMBS Loan Originations

The Takeaway

Two recent court decisions and a new piece of legislation from Michigan have spurred a ruckus over the relationship between the single-purpose entity (SPE)/separateness covenant on solvency and the typical CMBS non-recourse carve-out guaranty. The rulings in these cases turned on the interpretation of very specific language that, to a great extent, has been modified over the last few years through the natural interplay of market forces. There may be broader implications of the cases and statute, especially for existing loans, that take time to play out; for new originations, however, focusing on the precise language found in most current loan documents provides a navigable course for getting deals done today.

The Cases in Brief

In *Wells Fargo Bank, NA v. Cherryland Mall Limited Partnership*[1] (*"Cherryland"*), the Michigan Court of Appeals held a guarantor liable under its non-recourse carve-out guaranty on a defaulted loan because one of the SPE provisions was an unqualified covenant that the borrower would "not fail to remain solvent." The guaranty stated that any breach of the SPE covenants would trigger full recourse liability. The court found these provisions sufficiently clear from the face of the documents to disregard any evidence to the contrary as to the perception of such language in the marketplace.

In *51382 Gratiot Avenue Holdings, LLC v. Chesterfield Development Company, LLC*[2] (*"Chesterfield"*), a federal court in Michigan came to much the same conclusion, granting a judgment against the carve-out guarantor because it found that failure to make payments due under the loan breached the separateness covenant that the borrower would remain solvent and pay its debts as they became due. As in *Cherryland*, the law of Michigan governed the *Chesterfield* loan documents.

The Michigan Legislature Responds

In response to the two court decisions, the Michigan legislature rapidly enacted a new statute, titled simply the Nonrecourse Mortgage Loan Act, which overturns the holdings in *Cherryland* and *Chesterfield*, at least with

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1 *Wells Fargo Bank, NA v. Cherryland Mall Limited Partnership*, __ N.W.2d __, 2011 WL 6785393 (Mich.App 2011).

2 *51382 Gratiot Avenue Holdings Inc. v. Chesterfield Development Company*, 2011 U.S. Dist. LEXIS 142404 (E.D. Mich. Dec.12, 2011).

respect to loans made after the date of the statute. For such new loans in Michigan, the statute essentially prohibits enforcement of a guaranty based on the borrower's breach of a covenant to remain solvent and/or adequately capitalized. With respect to existing loans, the statute also purports to provide guidance to Michigan courts construing solvency covenants in existing loans.

The Developing Standard

Together, the two cases and the statute have understandably caused confusion among CMBS market participants. However, whatever the settled expectations may have been among many borrowers, lenders and servicers about the conceptual interplay between the solvency covenant and the recourse provisions, the cases emphasize that it is the actual language that is determinative. This sounds like a blinding glimpse of the obvious, but it does point the way forward on new originations. It is important to note that the unqualified language from *Chesterfield* and *Cherryland*, namely that a borrower shall remain solvent, full stop, is unlikely to be found in most CMBS documents today. In fact, the standard solvency covenant began changing years ago, ironically with a push from lenders concerned about the risk of substantive consolidation if the typical non-recourse carve-out guaranty turned out to in fact provide credit support for the mortgage loan.[3]

Below are two samples of the present day version of this SPE covenant, taken from the loan documents of several active CMBS lenders:

> Borrower has been, is and will remain solvent and Borrower has paid and will pay its debts and liabilities (including, as applicable, shared personnel and overhead expenses) from its assets as the same shall become due; <u>provided, that, in each such case, there exists sufficient cash flow from the Property to do so.</u>
>
> Borrower shall not undertake any action which would cause Borrower to become insolvent or to be unable to pay its debts as they become due, <u>provided there is positive cash flow from the operation of the Property to do so.</u>

Another relatively common variation is to require only that the borrower *intend* to remain solvent. These provisions may be even further refined to clarify, for example, that solvency for these purposes should be determined at the time of a particular action. Another approach is to expressly permit certain action (such as distributions to equity) in the ordinary course, so long as the distribution does not render the borrower insolvent. Even to the extent that a lender's form documents still provided for an unqualified solvency covenant, it appears (based on an anecdotal survey of those reasonably expected to know) that most CMBS lenders, well before *Cherryland* and *Chesterfield*, would routinely agree to qualify the language along the lines of the samples set out above if the borrower raised the issue during document negotiations.

These are all attempts to create a more realistic standard that is also consistent with the basic understanding of most market participants on the role that the solvency covenant plays, especially if backed by recourse. In such modified form, the solvency covenant should satisfy the concerns of both sides of a deal. From a

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[3] In a recent publication on the ruckus in Michigan, Moody's highlights this issue in noting that the risk to a lender of substantive consolidation is greater than the potential benefit from being able to pursue recourse based on the breach of a strict solvency covenant. *See* Daniel B. Rubock, "Michigan Nonrecourse Mortgage Loan Act Is Net Credit Positive for CMBS," Moody's Investors Service *Sector Comment*, April 2, 2012.

guarantor's perspective, it removes the possibility of a springing recourse claim simply because the mortgaged property is not generating sufficient cash flow. For lenders, it still provides a disincentive to inappropriately divert property cash flow, and also mitigates the risk of substantive consolidation.

While there is justifiable concern over the decisions in *Cherryland* and *Chesterfield* (and borrowers are rightly scrutinizing their existing loan documents to determine potential exposure), it is important to tap the brakes and take a step back from the cliff and consider that the market began to self-correct on this issue well before the cases came down. The qualified solvency covenants described above that are tied to appropriate parameters, such as intent or adequacy of property cash flow, provide stable footing for doing deals today.

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