ALERTS

The *Cherryland* Decision — Full-Recourse Enforcement of Non-Recourse Loans

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The economic decline in the real estate market has forced many borrowers of commercial mortgage-backed security ("CMBS") loans into default situations, which, in the case of some borrowers with non-recourse loans, can trigger full-recourse provisions to guarantors under their "non-recourse" guaranties. A recent opinion of Michigan's Appellate Court, if broadly adopted, would have a significant adverse effect on guarantors under their non-recourse guaranties. Under the reasoning of that court's decision in *Wells Fargo Bank, NA v. Cherryland Mall Limited Partnership*,[1] a lender would be allowed to foreclose on a defaulted non-recourse CMBS mortgage loan and then recover a deficiency (i.e., the excess of the debt over the foreclosure sale price of the property) from the non-recourse guarantor merely because the guarantor failed to keep the borrower solvent. A default under a non-recourse loan may allow lenders to foreclose, sell the collateral and recover the deficiency judgment from the non-recourse guarantor (i.e., the difference between the debt and the selling price of the property).

Background

Prior to the proliferation of non-recourse mortgage financing, a traditional mortgage loan usually involved a first lien mortgage secured by real property, and often, a personal guaranty from a principal of the borrower (or from an affiliated creditworthy entity of the borrower) from whom the lender could seek repayment on the mortgage debt. Changes occurred in the 1990s when CMBS loans became commonplace. In addition to opening up the capital markets to the real estate financing arena, the CMBS market was instrumental in establishing the development of non-recourse, asset specific lending.

In order to offer non-recourse loans, CMBS lenders require what is referred to as “asset isolation,” meaning that lenders will agree not to pursue recourse liability against the borrower or guarantor (other than for customary “bad boy” carve-outs as more particularly discussed below) so long as the financed asset is sufficiently protected from creditors of the parent and affiliates of the borrower. To successfully “isolate” an asset, CMBS loans typically require the borrower to make both separateness and single purpose entity (“SPE”) covenants in the borrower’s organizational documents and in the loan documents. These require the borrower to remain separate and distinct from its parent and its affiliates.

Referring to a CMBS loan as “non-recourse” may therefore be somewhat of a misnomer, because CMBS lenders will almost always require a principal of the borrower, or an affiliated creditworthy entity, to execute and deliver a personal guaranty in which the guarantor’s personal liability under the loan is triggered upon the violation of one of the “bad boy” carve-out exceptions. The extent of a guarantor’s liability for a “bad boy” act is dependent upon which carve-out exception is triggered from the “bad boy” act. For the most part, there are two different types of carve-outs: (1) “above the line” or “actual-loss” carve-outs in which the guarantor is liable only for any actual loss suffered by the lender as a result of the “bad boy” act; and (2) “below the line” or “full recourse” carve-outs, in which the guarantor is liable for the entire amount of the debt. A violation of the separateness or SPE covenants by the borrower will almost always trigger some recourse under the guaranty. Depending on how the loan documents were negotiated between the lender and the borrower, the breach of the SPE covenants will trigger either full recourse or just liability for actual loss — and this distinction is quite meaningful.

Cherryland Decision

The recent *Cherryland* decision from Michigan’s Appellate Court, which upheld a lower court decision ruling that the loan in question became fully recourse to the guarantor as a result of the borrower “[failing] to maintain its status as a single person entity” has many borrowers scrambling, and rightly so, and many lenders exercising their option to look to guarantors for repayment of defaulted loans. In October 2002, Cherryland Mall Limited Partnership (the "Cherryland Borrower") obtained an $8.7 million "non-recourse" mortgage loan (the "Cherryland Loan") from Archon Financial LP ("Archon"). As a condition precedent to making the Cherryland Loan, Archon required a principal of the Cherryland Borrower (the "Guarantor"; together with the Cherryland Borrower, collectively, the "Defendants") to execute a "bad boy" carve-out guaranty (the "Guaranty"), which provided, among other things, that a violation of the SPE covenants would trigger the Cherryland Loan to be fully recourse to Guarantor. Following the closing the Cherryland Loan, Archon sold the Cherryland Loan to Wells Fargo Bank, NA (the "Plaintiff") which later securitized the Cherryland Loan.

Eventually, an event of default occurred under the Cherryland Loan as a result of the Borrower's failure to make its required mortgage loan payments, which ultimately led to a foreclosure auction. At the foreclosure sale, the Plaintiff was the highest bidder, with a credit bid of $6 million, leaving a deficiency of close to $2.1 million from the amount owed under the Cherryland Loan. In an effort to recover the deficiency, the Plaintiff sued the Guarantor alleging that the Guarantor was liable for the full amount of the deficiency on the grounds that the Borrower breached the non-recourse covenants of the Guaranty, which required it to "maintain its status as a single purpose entity as required by, and in accordance with the terms and provisions of the Mortgage." *Cherryland* at 7. Plaintiff's argument, with which the lower court agreed, was that the SPE covenants in the Cherryland Mortgage (the "Mortgage") were all found under Section 9 ("Section 9 of the Mortgage"). Specifically, Section 9 of the Mortgage stated that the Borrower "covenants and agrees … that [the Borrower] is and will remain solvent and … will pay its debts and liabilities … from its assets as the same shall become due." The Plaintiff argued that the Borrower's failure to make mortgage loan payments resulted in its insolvency, thereby breaching an SPE covenant listed in the Mortgage. On Dec. 27, 2011, in a surprising ruling, the Court of Appeals of the State of Michigan affirmed the lower court's ruling.

The Defendants did not dispute that the Plaintiff would be entitled to full-recourse against the Guarantor under the Guaranty if the Borrower failed to maintain its status as an SPE; rather, the Defendants argued that the CherrylandNote, Mortgage and Guaranty all failed to properly define the term "single purpose entity" and that the provisions in Section 9 of the Mortgage, even under the heading entitled "Single Purpose Entity/

Separateness," were not clearly defined as SPE covenants that the Borrower was obligated to comply with under the terms of the loan documents.

The Court of Appeals' rationale in rejecting the Defendants' argument was that although the loan documents did not specifically define "single purpose entity," the itemized list of covenants under Section 9 of the Mortgage was customary and commonly found in CMBS loan documents and were customarily considered SPE covenants. In fact, the amicus briefs submitted on behalf of the Defendants by the Commercial Mortgage Securities Association and the Mortgage Bankers Association described the same provisions as were set forth in Section 9 of the Mortgage but referred to such provisions as "separateness covenants." Although this "could indicate that defendants [were] correct and that there [were] no SPE covenants contained in the mortgage, only separateness covenants," the Court of Appeals held that "separateness is a component part of SPE [status], such that maintaining SPE status requires abiding by the separateness covenants." *Cherryland* at 11. SPE provisions and separateness covenants are similar concepts and so, by claiming that Section 9 of the Mortgage contained only separateness covenants, the Court of Appeals found that the Defendants were actually conceding that Section 9 of the Mortgage contained the SPE covenants due to the fact that separateness covenants and SPE covenants are so intertwined.

Due to the interplay between the "separateness" and SPE concepts, the Court of Appeals also found that it was reasonable and logical that Section 9 of the Mortgage was entitled "*Single Purpose Entity/Separateness.*" Although the Cherryland Mortgage clearly stated that headings and captions "are for convenience of reference only and are not to be construed as defining or limiting, in any way, the scope or consent of the provisions," the Court of Appeals held that headings and captions are meant to provide reference points and to indicate where certain language will likely be found. *Id.* at 12, Pursuant to the Cherryland Loan documents, the Borrower was required to maintain its status as a "single purpose entity" as provided in the mortgage. Because the only reference to "single purpose entity" status in the mortgage was found in the heading of Section 9 of the Mortgage, the Court of Appeals concluded that "it [was] natural and logical to conclude that *all* of section 9, but that also *only* section 9, are the terms necessary to maintain SPE status." *Id.*

Additionally, the Court of Appeals found that the covenants set forth in Section 9 of the Mortgage are commonly considered SPE covenants. The Court of Appeals relied on case law that analyzed loan documents with similar or identical headings and provisions such as Section 9 of the Mortgage and, in each case, the respective court analyzing the applicable provision concluded that such covenants were in fact SPE covenants that if breached would result in full-recourse liability to the guarantor. *Id.*

The Defendants also argued that, in the alternative, even assuming that Section 9 of the Mortgage was the section setting forth the SPE covenants, the provision that required the Borrower to remain solvent was not breached because it was never the intention of the parties to make the Cherryland Loan full recourse to the Guarantor unless the Borrower became insolvent as a result of the Borrower's misappropriation of funds or its intentional or willful bad acts. The idea that a property owner would become insolvent due to a decline in property value, rather than an intentional or willful "bad acts," was never contemplated by the Defendants at the origination of the Cherryland Loan. The Court of Appeals rejected the Defendant's alternative argument as well because the loan documents did not specify the manner in which the insolvency must occur; rather, the loan documents clearly stated that "any failure to remain solvent, no matter what the cause, is a violation." *Id.* at 15. Additionally, the Court of Appeals was unwilling to explore the "intent" of the parties because the language in the loan documents was not ambiguous and would not require any extrinsic evidence in order to be interpreted. Contract law prohibits a court from resorting to extrinsic evidence to interpret language unless there is a question of the language's meaning.

Lastly, the Defendants argued that a holding which interpreted the carve-out language to allow for the Cherryland Loan to become full-recourse to the Guarantor if the Borrower became insolvent for any reason was against public policy and would lead to "economic disaster for the business community." *Id.* at 16. However, the Court of Appeals was unwilling to save the Borrower from a bad bargain and held that policy based change should come from the legislature and not the judicial bench.

Chesterfield Decision

In another case decided just days before *Cherryland*, the United States District Court for the Eastern District of Michigan came to a similar conclusion in *51382 Gratiot Avenue Holdings, LLC v. Chesterfield Dev. Co.* [2] In *Chesterfield* the borrower defaulted on its mortgage loan and the plaintiff sued the loan's guarantor for a deficiency of $12 million, created by the difference between the balance remaining on the loan and the value of the foreclosed property. Unlike in *Cherryland* however, the language in the *Chesterfield* loan documents was clear. It expressly provided that the loan would be fully-recourse against the guarantor if the borrower became "insolvent or fail[ed] to pay its debts and liabilities from its assets as the same shall become due." *Chesterfield* at 13. The *Chesterfield* court concluded that the language was not ambiguous and that a plain reading of the contract provided full-recourse when the borrower's debt exceeded the value of its assets (insolvency) and when borrower failed to make its mortgage loan payments on time (failure to pay debts and liabilities).

Conclusion

Commentators over the years failed to grasp the possibility that an economic decline could force borrowers into default, resulting in violations of the covenant to remain solvent and triggering the full recourse provision in the "bad boy" guaranties such as the one in *Cherryland*. The *Cherryland* ruling should have borrowers on high alert as it may provide lenders with a viable opportunity to recoup from guarantors any deficiency once a property is sold in a foreclosure sale. Borrowers should make sure that the carve-out language (and all other provisions of the loan documents) is clear and concise and reflects the intent of the parties that a non-recourse loan is truly non-recourse and only becomes recourse only for intentional and willful bad acts committed by a borrower. Borrowers may also want to examine their existing loan documents before taking any actions with respect to a specific loan. Understanding what will trigger full-recourse liability, even if it is not what the borrower believed it bargained for, may prevent borrowers and guarantors from being personally liable for their debt obligations.

If the *Cherryland* ruling is accepted by courts in other jurisdictions, many "non-recourse" loans will essentially become fully recourse loans. The Michigan Court of Appeals' interpretation of the SPE covenants in Section 9 of the Mortgage requiring the Cherryland Borrower to remain solvent essentially nullifies the whole concept of a non-recourse loan. The full effect of the *Cherryland* ruling is not yet clear; however, some are predicting a disastrous domino effect due to the fact that guarantors often guaranteed multiple CMBS loans, believing that they could not be held personally liable so long as they did not commit a willful or intentional bad act. Just one or two deficiency judgments against guarantors may cause their own insolvency, thereby triggering defaults on the other CMBS loans they guaranteed. Unfortunately for "non-recourse" guarantors, simply avoiding committing a willful or intentional bad act will not be sufficient if the *Cherryland* decision is accepted by courts in other jurisdictions.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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[1] *Wells Fargo Bank, NA v. Cherryland Mall Limited Partnership*, No. 304682 (Mich. Ct. App. Dec. 27, 2011). [2] *51382 Gratiot Avenue Holdings, LLC v. Chesterfield Dev. Co.* No. 2:11-cv- 12047 (E.D. Mich. 2011).

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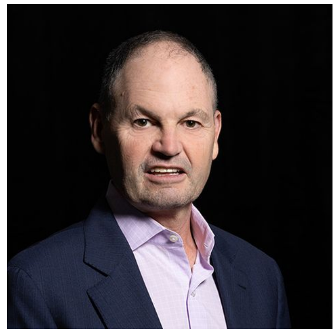

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