

# Guest Column: 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 securities 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 the State of Michigan Court of Appeals, 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*, No. 304682 (Mich. Ct. App. Dec. 27, 2011), a lender would be allowed to foreclose on a defaulted non-recourse CMBS mortgage loan and then recover a deficiency (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.

## Background

The CMBS market was instrumental in establishing the development of non-recourse, asset-specific lending. Referring to a CMBS loan as “non-recourse” may, however, 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 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”



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carve-outs, in which the guarantor is liable for the entire amount of the debt as a result of the bad-boy act.

A violation of the separateness or single-purpose entity 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 the Court of Appeals, 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 L.P. obtained an \$8.7 million non-recourse mortgage loan under which a principal of Cherryland executed a bad-boy carve-out guaranty. The guaranty provided, among other things, that a violation of the SPE covenants would trigger the Cherryland loan to be fully recourse to the guarantor.

Following an event of default under the Cherryland loan, the Lender sued the guarantor, alleging that the guarantor was liable for the full amount of the deficiency (the difference between the balance remaining on the loan and the value of the property) 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.” The lender 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 affirmed the lower court's ruling.

The guarantor did not dispute that the lender would be entitled to full recourse under the Guaranty if the borrower failed to maintain its status as an SPE; rather, the guarantor argued that the loan documents failed to properly define the term "single-purpose entity." The Court of Appeals' rationale in rejecting the guarantor's argument was that although the loan documents did not specifically define "single-purpose entity," the documents did contain "separateness covenants" that the borrower was required to comply with and that "separateness is a component part of SPE (status), such that maintaining SPE status requires abiding by the separateness covenants." The Court of Appeals rejected the guarantor's claim that the loan documents contained only separateness covenants and found that by making such an argument, the guarantor was actually conceding that the loan documents contained the SPE covenants, due to the fact that separateness covenants and SPE covenants are so intertwined.

The guarantor also argued that the provision that required the borrower to remain solvent was not breached because it was the intention of the parties to make the Cherryland loan full recourse to the guarantor only as a result of an intentional or willful "bad act" and not due to a decline in property value. The Court of Appeals rejected this 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." 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.

Lastly, the guarantor argued that a holding that 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." 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.

## 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 in loan documents accurately reflects the intent of the parties that a non-recourse loan is truly non-recourse and only becomes recourse for intentional and willful bad acts committed by a borrower.

If the *Cherryland* ruling is accepted by courts in other jurisdictions, many non-recourse loans will essentially become fully recourse. The Michigan Court of Appeals' interpretation of the SPE covenants requiring the 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 as 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. **CPE**

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