



TREND DEVELOPING: COURTS STRICTLY ENFORCING REOURSE CARVEOUTS GIVING RISE TO PERSONAL LIABILITY OF GUARANTORS

Borrowers typically think of CMBS loans as being recourse only to the collateral for the loan, *i.e.* the property. They also believe that if they cooperate with the lender after a default they will be able to walk away without personal liability under the loan so long as they do not do certain “bad boy” acts like misappropriation or waste of the collateral. However, recent cases are holding that if the recourse carveouts are triggered, whether inadvertently, and even cured, that the guarantors will become fully liable for the entire balance of the loan.

In December 2011, two decisions were handed down in Michigan, two weeks apart, both creating recourse liability to guarantors under the solvency recourse carveout in conduit loan documents.

In 51382 Gratiot Avenue Holdings, LLC v. Chesterfield Development Company, LLC, 2011 U.S. Dist. Lexis 142404 (E.D. Mich. Dec. 12, 2011), the Court enforced the single purpose entity covenant of the Borrower that it would not “become insolvent or fail to pay its debts and liabilities from its assets as the same shall become due.” The failure to make payments as they became due under the loan was found to violate this provision. Since the Guaranty made the loan a full recourse loan to the Guarantor in the event of a breach of any of the covenants in the single purpose entity provision, the Court found that the loan became a full recourse loan to the Guarantor as a result of this breach and granted a personal judgment of in excess of \$12 million against the Guarantor and in favor of the Lender.

Two weeks later, the Michigan Court of Appeals came to the same conclusion in Wells Fargo Bank, NA v. Cherryland Mall Limited Partnership, 2011 Mich. App. Lexis 2360 (Mich. App. 2011). While the carveout was expressed differently, the result was the same. In this case, the single purpose entity provision contained a provision that the Borrower shall not “fail to remain solvent or pay its own liabilities...only from its own funds...” Here, the Guaranty contained this provision and the Court enforced the provision granting a personal judgment of more than \$2 million against the Guarantor. The Court also relied upon a 2001 state trial court ruling.

These cases join a line of cases from other jurisdictions enforcing liability to guarantors as a result of violations of recourse carveouts. These cases include: LaSalle Bank, N.A. v. Mobile Hotel Properties, LLC, 367 F. Supp. 2d 1022 (E.D. La. 2004), enforcing liability as a result of the amendment of the articles of organization of the Borrower; Blue Hills Office Park LLC v JP Morgan Chase Bank, 477 F. Supp 2d 366 (D. Mass. 2007), enforcing liability as a result of a transfer of a part of the Mortgaged Property, a right to appeal a zoning case; and CSFB 2001-CP-4 Princeton Park Corporate Center, LLC v

SB Rental I, LLC, 980 A.2d 1 (N.J. Super. 2009), enforcing liability as a result of the Borrower obtaining subordinate financing, even though the subordinate debt had been repaid.

These courts are considering and rejecting the Borrower's arguments that the loans were intended to be nonrecourse so the documents should be reformed (*i.e.* revised) to meet this expectation. Since the language of the documents is clear, the courts are enforcing them as written. Also, the courts are refusing to change the documents based upon the enforcement being contrary to "public policy," that enforcement of the personal liability aspects of these loans will have disastrous consequences in the commercial real estate market. The courts are saying their job is to interpret the contract in front of them not enforce best business practices.

Legislation has been introduced in Michigan that would seek to overturn the Michigan cases and make the deficiency judgments in those cases unenforceable.

Finally, the Gratiot case, cited above, also acknowledged and held provisions of the Prenegotiation Agreement enforceable as well.

If you have any questions about the information contained in this Client Alert, please contact the Thompson & Knight attorney with whom you regularly work or one of the attorneys listed below for more information.

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