"SPRINGING RECOURSE" GUARANTIES ENFORCED IN RECENT DISTRICT COURT OPINIONS: WILL THE TREND CONTINUE? SHOULD *IN TERROREM* PROVISIONS BE ENFORCED?

by James H. Wallenstein[1]
Hunton & Williams LLP

This article updates two excellent papers that have recently been presented by RPTE eReport Real Property Editor Cheryl Kelly.[2] In fact, the impetus for this article is my having requested an update from Editor Kelly and then "volunteering" when she suggested that I perhaps provide for eReport an analysis of the two cases to which she alerted me in her update.

<u>Two Recent District Court Opinions on the Topic of "Springing Recourse"</u>

111 Debt Acquisition LLC v. Six Ventures, Ltd. et al., No. C2-08-768, U.S. District Court, S.D. Ohio, Eastern Division, Opinion and Order dated February 18, 2009, and published at 2009 WL 414181. In November 2006 Six Ventures, Ltd. refinanced six apartment projects with a $20,900,000 mortgage loan. The mortgage loan was non-recourse, meaning that the mortgagee could not pursue the borrower for a deficiency judgment after foreclosure; however, a guaranty executed by three guarantors provided that although their initial status with regard to the loan was also non-recourse, their status would convert to a full-recourse liability for the entire loan balance upon a "Springing Recourse Event," one of which was the borrower's filing for bankruptcy. In September 2008, after having defaulted in its mortgage payments, Six Ventures, Ltd. filed for bankruptcy. In October 2008 the bankruptcy court granted the mortgagee relief from the automatic stay, thus allowing the mortgagee to proceed with foreclosure against the properties. The borrower's bankruptcy filing, though, prompted the mortgagee to sue the guarantors for the full balance of the $20,900,000 loan, claiming that the bankruptcy filing was a "Springing Recourse Event" under the guaranty. In an Opinion and Order dated February 18, 2009, the District Judge in the *Six Ventures, Ltd.* litigation granted the mortgagee's motion for partial summary judgment, holding that the guarantors were liable for the full balance of the $20,900,000 loan. In his opinion the District Judge analyzed (i) whether or not the "Springing Recourse Event" provision in the guaranty and other loan documents was clear (in a quite extensive analysis, he found that it was clear), (ii) whether the mortgagee had followed proper trial procedure (he found that the mortgagee had done so), and (iii) whether the guaranty provision violated public policy by discouraging debtors from filing for bankruptcy protection (he found that it did not violate public policy). However, the District Judge's Opinion and Order contains no discussion of whether the springing recourse provisions, which in this instance would cause the guarantors' liability to increase from zero to an amount approaching $20,900,000, might have prescribed an unenforceable "penalty" since the effect of the borrower's prohibited action appears to have resulted in nothing more than an approximately one-month delay in the mortgagee's foreclosure process.

---

[1] JAMES H. WALLENSTEIN is a Counsel in the Dallas office of Hunton & Williams LLP, with his resume being printed at www.hunton.com/bios/bio.aspx?id=17400&tab=0013. He can be reached at (214) 468-3391 or by e-mail at jwallenstein@hunton.com. Especially in light of the admittedly editorial tone of some of the author's analysis, he makes the following disclosure and disavowal: (1) the author's clients are predominantly real estate developers and investors, i.e., not mortgage lenders; and (2) the author's comments are solely his personal observations and conclusions, and they in no way represent the views of his law firm or any clients of his law firm.

[2] Kelly, *Real Estate Work-Outs: Running Dry in the Liquidity Crunch?* June 19, 2008 Telephone Seminar/Audio Webcast sponsored by the American College of Real Estate Lawyers, printed at the following internet web page: http://files.ali-aba.org/thumbs/datastorage/skoobesruoc/pdf/TSNR01_chapter_02_thumb.pdf , which in turn updates Kelly, *Enforcement of Guaranties Including Carve Outs from Recourse Liability and Springing and Exploding Guaranties*, ACREL Fall 2007 Meeting presentation.

Compare *FDIC v. Prince George Corporation*, 58 F.3d 1041 (4th Cir. 1995), which was decided under a different form of limited guaranty provision, i.e., so-called "carve-out" liability for actual losses instead of springing liability on the entire loan amount, and which shows that a court can determine the actual loss that a lender incurs when the borrower violates the no-bankruptcy provisions in loan documents.

CSFB 2001-CP4 Princeton Park Corporate Center, LLC vs. SB Rental I, LLC, et al., No. L-7224-06, Superior Court of New Jersey, Law Division, Middlesex County, unpublished transcript of an oral opinion and order issued March 28, 2007 (supplied to me courtesy of Cheryl Kelly). This still-pending litigation involves a $13,300,000 non-recourse mortgage loan to SB Rental I, LLC, subject to the possibility of springing recourse liability for the full $13,300,000 loan amount being imposed on one or more guarantors (the style of the case includes "et al" and both the style and the District Judge's opinion refer to the plural "defendants") in the event that SB Rental I, LLC placed any subordinate financing on the property. SB Rental I, LLC did place subordinate financing on the property, and in his March 28, 2007 opinion the District Judge held that the loan was therefore fully recourse to the guarantor(s). In addition to a discussion in the District Judge's opinion of whether the springing recourse provision was clear (he held that it was clear), the opinion also included a discussion of whether having the guarantor's(s') liability increase from zero to $13,300,000 due to the borrower's placing a subordinate financing on the property might have prescribed an unenforceable penalty. However, the court did not analyze whether the mortgagee had suffered any actual damages from the subordinate financing (in most states the foreclosure of a superior lien wipes out a subordinate lien), but instead pointed out that the "defendants" -- plural -- "received and retained $13.3 million in loan proceeds" and that the imposition of $13,300,000 liability on the guarantors for the borrower's subordinate financing was "actual damages" because: "In fact, the damages which the plaintiff seeks are equal to the outstanding loan balance and nothing more." The District Judge did not attempt to distinguish between damages caused by the borrower's failure to pay the loan (which was not a springing recourse event) and damages caused by the borrower's subordinate financing.

<u>A Trend in Enforcing Springing Recourse Provisions and the Presumed Rationale for Such Enforcement</u>

During the past several years, other reported cases in addition to the two cases discussed above have enforced springing recourse loan provisions. See, in reverse chronological order: *Blue Hills Office Park LLC v. JP Morgan*, 477 F. Supp. 2d 366 (D. Mass. 2007); *LaSalle v. Mobile*, 367 F. Supp. 2d 1022 (E.D. La. 2004); *Heller Financial v. Lee*, 2002 U.S. Dist. LEXIS 15183 (N.D. Ill. August 12, 2002); and *First Nationwide Bank v. Brookhaven Realty Association*, 637 N.Y.S. 2d 418 (N.Y. App. 1996). See also three excellent recent articles on the subject, all of which are located on readily accessible internet web pages: Kelly, *Real Estate Work-Outs: Running Dry in the Liquidity Crunch?* http://files.ali-aba.org/thumbs/datastorage/skoobesruoc/pdf/TSNR01_chapter_02_thumb.pdf (June 2008); Kuney, *"Springing Guarantee" Fully Enforced in Non-recourse Mortgage Loan: for Borrower's Loan Breaches Including the Failure to Comply with Separateness Covenants*, www.sidley.com/db30/cgi-bin/pubs/Bankruptcy_Update_08.20.07.pdf (August 2007); and Murray, *Carveouts to Nonrecourse Loans: They Mean What They Say!* http://www.firstam.com/content.cfm?id=2920 (2007).

As was the case in the *Six Ventures, Ltd.* opinion, in most of the above-cited court opinions the judge failed to consider the "penalty" issue at all in his opinion. Generally implied, if not always expressed, in the opinions was a rationale similar to the following: (i) the lender made a loan, and a borrower customarily has liability for repaying a lender's loan; (ii) in the particular loan in question the lender made a unique exception, granting the borrower and its guarantor(s) exculpation from the repayment obligation if, but only if, the borrower "kept its end of the bargain" by refraining from the specified springing recourse activities; (iii) since the borrower did not so refrain, the borrower and the guarantor(s) were not entitled to the lender's unique exception, and the customary obligation of repayment returned.

This Author's Analysis and Conclusion[3]

It is the opinion of this author that the business dialogue in most mortgage loan transactions does not follow the rationale that was set out in the immediately preceding paragraph. Instead, the business dialogue generally follows a format such as the following:

> Borrower (before any loan commitment is issued): "The loan is a non-recourse loan, right?"
> Lender: "Yes, that's the deal."
> Borrower (after receiving the lender's loan commitment): "I see the paragraph that says the loan is non-recourse, but it mentions something about your customary carve-out provisions. What are those?"
> Lender: "Don't worry about that; it's just our legal department's standard stuff. Your lawyer can work out the language with our lawyer in the final loan documents."
> Lender's Lawyer to Borrower's Lawyer (during document negotiations): "The commitment says the documents will contain our customary carve-out provisions, and the springing recourse paragraph is standard for us. I don't have the authority to delete it. Just tell your client not to do anything that is prohibited by the paragraph, and there won't be any problem."

While no research has been done other than the author's recollection of his professional experience during the past 38 years to justify the above-quoted scenario, the author believes that a polling of lenders and borrowers about their pre-commitment and contemporaneously-with-commitment verbal dialogue would reveal scenarios very similar to what is quoted above. And, more importantly, the author believes that not a single lender would have answered the borrower's first question in the above scenario with an analysis similar to what was set out in the paragraph of this article that precedes the scenario. Similarly, it is this author's belief that if lenders were polled about why springing recourse provisions are included in their loan documents, not a single one would say that the principal purpose of the springing recourse provisions was to give the lender full-recourse remedies. Instead, they would say that such springing recourse provisions are included to make it prohibitive for the borrower to act improperly -- what some courts and commentators refer to as ***"in terrorem"*** clauses, i.e., clauses whose primary purpose is to place the borrower ***in terror*** against performing the proscribed action. This conclusion is corroborated by occasional references in speech presentations where the speaker uses the term "***in terrorem***" to describe the springing recourse provisions, such as Barton, *Carveouts, Deficiencies, and In Terrorum* [sic] *Clauses*, 2004 Texas Mortgage Lending Institute.

Other than perhaps in the context of will contests, *in terrorem* provisions are not favored by courts. For example, in the case of *Muller v. Light*, 538 S.W.2d 487 (Tex. Civ. App. -- Austin 1976), the court characterized a purported liquidated damages provision in a construction contract to be "an ***in terrorem*** device to insure prompt performance by the builder" and, accordingly, an unenforceable penalty. Similarly, in *Raffel v. Medallion Kitchens of Minnesota, Inc.*, 139 F.3d 1142 (7th Cir. 1998), the court found a purported liquidated damage provision in a lease to be an unenforceable penalty and, in doing so, favorably quoted the following language from a 1915 opinion from the Illinois Supreme Court: ". . . if it [the damage clause in a contract] appears to have been inserted to secure the prompt performance of the agreement, it will be treated as a penalty and no more than actual damages can be recovered." 139 F.3d at 1146. The same court later cited its *Raffel* opinion favorably and described the basis for its decision with essentially the same language in its opinion in *Checkers Eight Limited*

[3] This would be a good time to reemphasize the disclosure and disavowal that is stated in footnote 1 above: (1) the author's clients are predominantly real estate developers and investors, i.e., not mortgage lenders; and (2) the author's comments are solely his personal observations and conclusions, and they in no way represent the views of his law firm or any clients of his law firm.

Partnership v. Hawkins, 241 F.3d 558, 562 (7th Cir. 2001), in holding unenforceable a stipulated fee for failing to make a settlement payment within the prescribed time period. Accord: *In re Dow Corning Corp.*, 419 F.3d 543 (6th Cir. 2005) and *MCA Television Limited v. Public Interest Corporation*, 171 F.3d 1265, 1271 (11th Cir. 1999), which opinions are listed in support of the following statement in 24 WILLISTON ON CONTRACTS, page 249: "Accordingly, a specified sum that is unreasonably large when compared to the damage that could have been anticipated from the breach of the contract, and therefore punishes the breach, is a penalty, as is a sum which is designed to or has the effect of coercing performance of the contract by making the breach so expensive that it forces adherence to the contract."

For a sampling of real estate related court opinions in the author's State of Texas on the issue of penalty versus liquidated damages, see *Flores v. Millennium Interests, Ltd.*, 185 S.W.3d 427 (Texas Supreme Court 2005) (characterizing as an unenforceable penalty a statutory "liquidated damage" provision in connection with a contract for deed); *Stewart v. Basey*, 245 S.W.2d 484 (Texas Supreme Court 1952) (characterizing as an unenforceable penalty a liquidated damage provision in a lease agreement); *Tri-Cities Construction, Inc. v. American National Insurance Company*, 523 S.W.2d 426 (Tex. Civ. App.--Houston [1st Dist.] 1975, no writ), appeal after remand, 551 S.W.2d 106 (Tex. Civ. App.--Houston [1st Dist.] 1977, no writ) (holding a mortgage loan commitment fee to be an unenforceable penalty); *Ashton v. Bennett*, 503 S.W.2d 392 (Tex. Civ. App.--Waco 1973, writ ref'd n.r.e.) (holding an earnest money deposit in a real estate contract of sale to be an unenforceable penalty). See also, among many other sources, the following general analyses on the subject: RESTATEMENT OF THE LAW (SECOND) OF CONTRACTS (1981), pages 157-61, § 356 ("Liquidated Damages and Penalties"); and 24 WILLISTON ON CONTRACTS, pages 248-57, §§ 65:3 and 65:4 ("Distinction between penalties and liquidated damages").

It is the opinion of this author that court opinions referring to the springing full liability as being "actual damages" [Excerpt from the *SB Rental I, LLC* opinion: "In fact, the damages which the plaintiff seeks are equal to the outstanding loan balance and nothing more."] mistakenly confuse the damages caused to the lender by the borrower's failure to repay the loan (which is not a recourse event and, in fact, is generally the basis for the non-recourse exculpatory language) with the damages caused to the lender by the borrower's taking an action that is proscribed in the springing recourse provision. It is also the author's opinion that the judges' opinions in cases such as the two that precipitated this report often reflect an impatience on the part of the judges with the certain specific prior actions or court arguments of the respective defendants. This author predicts a different line of reasoning, i.e., with a thorough analysis of the "penalty" aspect of *in terrorem* clauses, in a future appellate court decision. And this author would especially predict a court's rejection of the springing recourse remedy in the event of litigation involving a guarantor whom the judge does not suspect of having drained the property of cash but instead has merely succumbed to an economic downturn, who has not attempted to delay the lender's foreclosure, and who is now being sued by the lender for the entire loan balance on account of a specified springing recourse action that caused little or no expense to the lender, such as, for example, a prohibited transfer of an insignificantly small, non-controlling limited partner's interest (and for this example, not the interest of the guarantor) or a violation of one of the "single purpose entity" provisions by the borrower's having occasionally used the wrong forms for obtaining materials for the property.