Enforceability of Carveouts to Nonrecourse Loans: An Update

By John C. Murray

Introduction

Since the mid-1980s, lenders have been qualifying and restricting nonrecourse provisions in commercial real-estate loans by making exceptions for certain "bad acts" by borrowers. In recent years, many lenders have expanded the scope of such "carveouts" to include risks of exposure to the property's economic deterioration or neglect. Some nonrecourse provisions provide that the borrower is liable for the specific damages resulting from the violation or breach of a carveout, while others state that the entire loan becomes recourse to the borrower if any of (or certain of) the excepted acts occurs. In some cases the exceptions have virtually swallowed the rule; i.e., the clause is drafted so that the borrower has personal liability for virtually all defaults except the failure to pay the principal and interest due on the loan. There has been relatively little case law regarding the validity and enforceability of such carveouts, as these provisions have rarely been challenged by borrowers or guarantors. But in the current severely depressed commercial real estate market, with the commensurate increase in mortgage loan defaults, more federal and state court actions challenging the validity and enforceability of carveout provisions are being brought by borrowers and guarantors (mostly without success). This article will discuss and analyze the relevant court decisions in this area.

The *Heller v. Lee* Decision

A. Background.

In *Heller Financial, Inc. v. Lee* (not reported in F. Supp. 2d), 2002 WL 1888591 (N.D. Ill., August 16, 2002), the court rejected a challenge to the enforceability of a specific exception to the nonrecourse provision in the note executed by the borrower. The borrowers, Harry Lee ("Lee") and L. Joe VanWhy ("VanWhy"), along with others, formed a Florida limited partnership, Royal Plaza, Ltd. ("Royal Plaza"), to purchase the Hotel Royal Plaza ("Hotel") in Orlando, Florida. Madlee, Inc. ("Madlee"), a Florida corporation, served as the general partner of Royal Plaza. Royal Plaza and Maddlee obtained two loans to purchase the Hotel, one for approximately $34 million from Bankers Trust Company, and the other (the subject of the litigation in this case) from Heller Financial, Inc. ("Heller") for approximately $10 million ("Loan"). Lee, VanWhy, and Royal Plaza, Ltd. executed an Equity Loan Agreement ("Loan Agreement") and a Promissory Note ("Note") in connection with the Loan, which was essentially a mezzanine financing transaction. Heller also obtained pledges of the general and limited partnership interests in Royal Plaza and perfected a UCC security interest in these "general intangibles" by properly filing UCC-1 financing statements.

The Note contained a nonrecourse provision, which provided that no maker would be personally liable to pay the Loan or to perform any obligation under the Loan documents, and that the holder of the Note would look solely to "the Assignments and any other collateral heretofore, now, or hereafter pledged by any party to secure the Loan." The Note further provided that notwithstanding the nonrecourse nature of the Note, each maker (except for one individual maker, Robert Ahnert) would be personally liable, jointly and severally, for repayment of the Loan "and all other obligations of Maker under the Loan Documents" in the event of any breach of certain covenants in the Loan Agreement "pertaining to transfers, assignments and pledges of interests and additional encumbrances in the Property, the Partnership or the Corporation." One of the specific carveout covenants in the Note stated that each of the makers would "not [without the prior consent of the lender] . . . grant or permit the filing of any lien or encumbrance on the Project, the Collateral or the general partnership interest of the Corporation in the Partnership," other than those created by the senior loan documents and certain personal property leases; provided that Royal Plaza could contest the validity or amount of any asserted lien if it gave prior written notice to Heller, such contest stayed the enforcement of the contested lien, and the contested lien was bonded or insured over by the title insurance company or Royal Plaza posted security in a manner acceptable to Heller.

After the purchase of the Hotel by Royal Plaza, six liens (in the form of tax liens and mechanic's liens) were placed against the Hotel, none of which was consented to by Heller or of which Heller was notified, and none of which was bonded over or insured by the title insurance company. As a result of these liens, Heller declared a default under the Loan and informed Lee, VanWhy, Royal Plaza, and Madlee that the entire outstanding Note balance was due and payable and that a public sale of the equity interests (in accordance with UCC requirements) in Royal Plaza and Maddlee (which had been pledged to Heller as security for the Loan) would occur. The Hotel and part of the equity interests of Royal Plaza were subsequently sold (at which Heller bid the outstanding principal and interest due on the Loan) and the proceeds thereof paid to Heller. Heller then filed the instant action, claiming that it had not received payment in full on the Note and that Lee and VanWhy were personally responsible for the deficiency.

B. The Court's Decision.

Lee and VanWhy argued that they were not responsible for, and had no knowledge of, the liens placed against the Hotel because it had been managed "with the knowledge and agreement of Heller" by a separate management company unrelated to Royal Plaza. The court rejected this argument, stating that "Lee and VanWhy contracted with Heller for the loan and not [the manager]. Further, Lee and VanWhy cannot claim ignorance of the liens when they were a matter of public record." *Id.* at *2, fn. 2.

The court stated that under Illinois law (which all the parties agreed governed the loan transaction), a loan would be deemed to be nonrecourse where the borrower "is not personally liable for the debt upon default, but rather, the creditor's recourse is solely to repossess the property granted as security for the loan" (citations omitted). *Id.* at *4.

Under this definition, the court ruled that the loan from Heller was a nonrecourse loan. However, the court noted that lenders commonly create certain carveouts to nonrecourse provisions in loans to "provide the protection that lenders require, personal liability, to insure the incentive to repay the loan and maintain the viability of the loan." *Id.*

Heller contended that a violation of any of the carveouts stated in the Note, including the exception to nonrecourse for any lien placed on the Hotel, would cause Lee and VanWhy to become personally liable for the principal balance of the Loan. Lee and VanWhy argued that the carveouts were actually liquidated damages provisions and were unenforceable as penalties. The court rejected this argument, ruling that the carveout language was unambiguous and clearly provided for personal liability for violation of the enumerated exceptions to nonrecourse, including the placing of liens against the Hotel. The court noted that the carveouts had been negotiated and agreed to by all parties, as evidenced by the fact that one of the makers of the Note, Robert Ahnert, had exempted himself for any personal liability for violation of the carveouts. The court also agreed with Heller's assertion that because the Loan was secured by the equity interests of the entities that purchased the Hotel and not the Hotel itself, Heller was especially concerned about the operation of the Hotel because it directly affected the value of the collateral securing the Loan, i.e., Heller could not foreclose on the real property interest and the liens against the property were not truly "junior" to Heller's UCC security interest, and could in fact have devalued Heller's security interest. As the court succinctly summarized, "[i]t is painfully clear that the nonrecourse loan from Heller to Royal Plaza and Madlee included carve-outs. Further, these carve-outs caused Lee and VanWhy to be personally liable. Lee and VanWhy acknowledged and agreed to this." *Id.* at *5.

The court also rejected Lee and VanWhy's argument that Heller should be prohibited from enforcing the carveout from the nonrecourse provision because it constituted a liquidated damages penalty. The court found that the section of the Note dealing with the nonrecourse carveouts was not a liquidated damages provision because it provided for only the recovery of actual damages incurred by Heller, i.e., the amount of the unpaid Loan indebtedness at the time of the default. Therefore, according to the court, "[t]his amount is the actual damages to Heller based on Lee and VanWhy's breach. Since [the carveout section of the Note] involves actual damages it cannot be a liquidated damages provision." *Id.*

Discussion

1. True nonrecourse loans are rare today. Commercial real estate values have substantially declined. In the past (and even currently, to a lesser extent) much real estate value was created by investors seeking tax or related benefits who were not particularly concerned about adding to – or in some cases even maintaining – the value of the property, or by foreign investors seeking unique opportunities or higher returns (however modest) than were available in their own countries. Many lenders began to realize – especially after being "burned" in bankruptcy proceedings filed by or against their borrowers – that standard nonrecourse mortgage provisions in some cases actually

encouraged borrowers to contest lender enforcement actions and to file bankruptcy proceedings, as borrowers had no risk of personal liability and could delay or even avoid unfavorable tax consequences. Lenders learned that, because of the absence of personal risk to borrowers and the lack of a direct monetary incentive for borrowers to properly operate and maintain the property, their security could suffer a substantial loss in the value that was originally determined as the basis for underwriting the loan.

2. The carevout exceptions to nonrecourse mortgage provisions have evolved from the traditional borrower "bad acts," such as fraud and material misrepresentation and the diversion of the loan proceeds, to include matters of conduct (or inaction or misconduct) related to the economic performance of the property, such as the misapplication of rental income, environmental contamination of the property, and physical or economic waste of the property. The exceptions to nonrecourse have expanded to include obligations to properly maintain the property and preserve its value.

3. It certainly is hard to argue with the court's decision in *Heller v. Lee, supra*, based on the facts of the case. However, the precedential value of this decision may be somewhat limited, at least with respect to the validity and enforceablity of carveouts to nonrecourse provisions in mortgage loan documents. As the court in *Heller v. Lee* stated, "the loan was secured by the equity interests of the entities that purchased the Hotel, and not by the Hotel property itself. This means Heller is concerned with the successful operation of the Hotel since it affects the value of the collateral that secured the loan. Any lien on the property compromises the equity interests of Royal Plaza and Madlee. Thus, the carve-out under [the nonrecourse section of the Note] is of the utmost importance in acquiring the loan and is known and agreed to by all the parties." *Id.* at *4. But the same rationale underlies the insertion of carveouts in nonrecourse mortgages: the prevention of deliberate "bad acts" by the borrower or the occurrence of acts or events that diminish the value of the property or divert or misapply the cash flow derived therefrom.

4. With respect to the argument that carveouts from nonrecourse provisions are unenforceable liquidated damages provisions, the court stated that, at least in Illinois, "courts lean toward a construction that excludes the idea of liquidated damages and permits the parties to recover only damages actually sustained (citations omitted)." *Id.* at *5. The carveout provision in *Heller v. Lee* provided that the makers of the Note (with the exception of Robert Ahnert) would become personally liable, jointly and severally, for the entire outstanding balance of the loan "and all other obligations of Maker under the Loan Documents" if any of the enumerated exceptions (including liens created against the Hotel) occurred. The six liens placed on the Hotel property were for an aggregate amount of approximately $820,000, and occurred over a five-month period of operation of the Hotel. Although the amount of the unpaid balance due on the Loan at the time of default is not stated in the court's opinion, the author's understanding is that it was almost the entire principal balance of $10 million (the Loan was interest only). The court noted that as a result of the violation of the covenant not to place liens against the property, there had been a public sale of both the Hotel and "the equity interest in Royal Plaza and Maddlee, which had been pledged to Heller as security for the Heller loan," *Id.* at *2. Even though Heller received proceeds from the sale covering a portion of the debt, in the

amount of approximately $5 million, it argued that its "actual damages" consisted of the remaining unpaid deficiency amount of approximately $5 million, which became due when the borrower failed to pay the approximately $820,000 due as the result of the liens recorded against the property, i.e., Heller had agreed not to seek personal liability for any deficiency only so long as none of the carveouts had been breached. Heller likely argued, during the arguments before the court with respect to the actual damages incurred by Heller (the court determined that Lee and VanWhy were liable under the carveout, but not the actual damages), that it was entitled to all its out-of-pocket expenses and advances to preserve its security interest, including payments under the ground lease (the Hotel was on ground-leased property); payments due under the $34 million loan from Bankers Trust Company; other unpaid encumbrances and liens (in the approximate amount of $3 million); government impositions; default interest; attorneys' fees; payments to vendors; unpaid taxes and insurance premiums; and expenses to obtain new management.

5. Many nonrecourse mortgage loans now contain covenants providing that the entire loan becomes recourse to the borrower if certain "blameworthy" defaults occur, i.e., those that are exclusively within the borrower's control. The borrower typically will strongly resist the imposition of conditions or covenants that would negate the nonrecourse provision and result in full personal liability, and will attempt to limit the lender's remedies to foreclosure and other rights solely related to the property (or, at most, quantifiable and limited damages). The following are examples of the types of "bad acts" of most concern to lenders, the breach of which many lenders believe should result in the imposition of full recourse liability against the borrower because they are within the sole control of the borrower: violation of the due-on-sale-or-encumbrance clause; violation of the prepayment premium provision; the voluntary filing of a bankruptcy or reorganization proceeding; contesting the lender's foreclosure action or asserting a "lender liability" claim, affirmative defense, or counterclaim; environmental contamination of the property; and fraud and material misrepresentations regarding the borrower, the loan, the rental income from the property, or the condition of the property.

On the other hand, certain carveouts relating to the lender's efforts to protect itself from a loss of the property's value, or the diversion, misappropriation, or misapplication of the property's income stream, may be more amenable to a limited quantifiable-damages remedy. The following are examples of these types of covenants: the failure to properly apply insurance or condemnation proceeds to the restoration or repair of the property and the improvements thereon; the diversion or misapplication of security deposits and unpaid rents; the misapplication or diversion of rental income after a loan default; the failure of the borrower to perform its obligations as landlord under leases in effect on the property; physical neglect or waste of the property; "economic waste" of the property (such as the failure to pay property taxes and assessments); failure to discharge mechanic's liens and other monetary encumbrances and judgment liens against the property; failure to insure the property or pay the insurance premiums when due; failure to comply with applicable laws and regulations affecting the property; failure to maintain the property in a "suitable condition" to prevent loss of value; and removing or "stripping" personal property essential to the use and operation of the property and the buildings and improvements thereon. *See generally* Portia Owen Morrison and Mark A.

Senn, *Carving Up the 'Carve-Outs' in Nonrecourse Loans*, 9 PROB. & PROP. (1995); Gregory M. Stein, *The Scope of the Borrower's Liability in a Nonrecourse Loan*, 55 WASH & LEE L. REV. 1207 (1998); Miroslav M. Fajt and Gary S. Litke, *Nonrecourse Carveouts: Striking Right Balance for Real Estate Loans; Expanding the List Can Lead to Delays*, NEW YORK LAW JOURNAL (Sept. 25, 2000), p. S1; Joshua Stein, *Nonrecourse Carveouts: How Far is Far Enough?*, REAL ESTATE REVIEW (Winter 1997), p. 3; Gary Marsh, *Enforceability of Carve-Out Clauses in Non-Recourse Loans*, CMBS WORLD (Winter 2007); Darryl Steinhause, *Non-Recourse Carve-Outs Do Matter*, REAL ESTATE SOUTHERN CALIFORNIA, June 2006, at p. 34.

6. The courts that have ruled on the validity and enforceability of carveouts to nonrecourse provisions generally have construed them in favor of lenders, rejecting borrower and guarantor claims of ambiguity, merger, lack of harm, or invalidity under specific provisions of the Bankruptcy Code. For example, in *First Nationwide Bank v. BrookhavenRealty Assocs.*, 637 N.Y.S.2d 418 (1996), *appeal dismissed*, 88 N.Y.2d 963 (1996), the borrower, a real-estate general partnership, entered into a nonrecourse mortgage with a carveout that provided that the partnership and its individual partners would become individually liable if a bankruptcy proceeding was commenced by or against the partnership and was not dismissed or otherwise resolved within 90 days after the filing. After defaulting on the loan, the partnership filed a bankruptcy proceeding that was not dismissed until well after the 90-day period had expired. Following the dismissal of the bankruptcy proceeding, the lender then sought a determination that it was entitled to a deficiency judgment against the partnership and the individual partners because the bankruptcy filing had triggered the right to seek such personal liability. The partnership and its partners argued that the bankruptcy-contingent liability was unenforceable under § 365(e) of the Bankruptcy Code, which prohibits the enforcement in bankruptcy of "ipso facto" clauses in executory contracts (i.e., provisions that provide for the termination or modification of the contract conditioned solely on the insolvency or financial condition of the debtor or the commencement of a bankruptcy proceeding). The court rejected this argument on numerous grounds, including the facts that the ipso facto prohibition applies only to executory contracts, not mortgages, and that once the bankruptcy case had been dismissed the enforceability of the carveout was a matter of state law rather than bankruptcy law. The court reasoned that the federal bankruptcy policy of providing a debtor with a fresh start and an opportunity to reorganize were not present in a foreclosure proceeding. The court, in upholding the right of the lender to enforce the carveout, stated that, "[as] a bankruptcy default clause is enforceable under the laws of [New York'] [citation omitted], the one at issue here should be enforced. The [partnership and its partners] are bound by the terms of the contract and enforcement of the bankruptcy default clause is neither inequitable, oppressive, or unconscionable [citation omitted]. Moreover, the recovery of a deficiency judgment is specifically contemplated by statute [citation omitted]." *Id.* at 421.

In *FDIC v. Prince George Corp.*, 58 F.3d 1041 (4th Cir. 1995), the court upheld the lender's right to sue a joint venturer for a deficiency judgment on the joint venture's nonrecourse mortgage note, which contained a carveout providing for personal liability if the lender's rights were impaired, reduced or suspended "as a result of any act, omission or misrepresentation . . . or by or as a result of any case, action, suit, or proceeding to which [the borrower or any other liable party] voluntarily becomes a party." The Fourth Circuit reversed the lower court ruling in favor of the joint venturer, rejecting the joint venturer's argument that the borrower had a statutory right to bankruptcy protection and that any waiver of that right was void as against public policy. The court noted that the contract did not prevent the borrower from filing a bankruptcy proceeding, it merely provided that if the borrower took certain actions it would forfeit its exemption and become personally liable for payment of the loan. The court held that the carveout language was unambiguous and imposed deficiency liability for "any act" that impaired the exercise of the lender's remedies (including foreclosure). The court remanded the case for a determination of liability based on the delays caused by both the bankruptcy proceeding and the borrower's defense of the foreclosure action.

But the *Brookhaven* and *Prince George* cases, *supra*, may not provide firm precedents because in both cases the bankruptcy proceedings had been terminated prior to the legal actions involving the personal guarantee and each debtor had very few (if any) other creditors. *See* Marshall E. Tracht, *Insider Guaranties in Bankruptcy: A Framework for Analysis*, 54 U. MIAMI L. REV. 497, 548 (2000):

> While both of these cases enforced bankruptcy-contingent liabilities, they should provide little comfort to lenders. In each case, the bankruptcy proceeding had been dismissed prior to the initiation of the guaranty suit, making these poor candidates to test the robustness of springing guaranties in the face of a strong bankruptcy policy argument. Moreover, both cases were single-asset realty cases, meaning that the borrowers had few, if any, creditors other than the mortgagee. As a result, state law fiduciary duties that might have been owed to creditors were not relevant either. In other words, these were the easy cases, to which the arguments against bankruptcy-contingent guaranties do not readily apply.

See also GCCFC 2006-GG7 Westheimer Mall, LLC v. Okun, 2008 WL 3891257 (S.D.N.Y., Aug. 21, 2008) (holding that guarantor under non-recourse loan was liable, under non-recourse carveout provision in loan documents, for full amount of loan under specific terms of loan guaranty when borrower filed a voluntary bankruptcy petition); *111 Debt Acquisitions LLC v. Six Venture, Ltd.*, 2009 WL 1255102 (S.D. Ohio, May 4, 2009) (ruling that provision in guaranty, combined with language in loan agreement, providing for full recourse liability for violation of specific carveouts, was enforceable against guarantors if borrower filed for bankruptcy); *W.F.M. Restaurant, Inc. v. Austern*, 35 N.Y.2d 610, 616-17 (1974) (upholding right of landlord to terminate lease under a "bankruptcy clause" in the lease, where involuntary bankruptcy petition against lessee had been dismissed and state court had sole jurisdiction to resolve the dispute).

Pursuant to § 365(e) of the Bankruptcy Code, clauses that terminate or modify a debtor's rights in an executory contract upon the filing of a bankruptcy petition are generally rendered unenforceable and are known as "ipso facto" clauses. However, § 365(e)(2)(B) provides an exception to this rule if the contract "is a contract to make a loan, or extend other debt financing or financial accommodations, to of for the benefit of the debtor, or to issue a security of the debtor." *See, e.g., Mims v. Fidelity Funding, Inc.*, 2002 U.S. Dist. LEXIS 19820 (N.D. Tex., Oct. 15. 2002) (holding that revolving credit loan agreement secured by all of borrower's accounts receivables, which contained provision that filing of bankruptcy petition constituted event of default making all of debtor's obligations under loan agreement immediately due and payable, was enforceable, and stating that "it is clear that the Bankruptcy Code's invalidation of *ipso facto* clauses does not apply in this situation involving a contract to make a loan for the benefit of the debtor"). *Id.* at *21.

7. For cases involving non-bankruptcy issues that have upheld the right of the lender to enforce specific carveout provisions in nonrecourse loans, *see Diamond Point Plaza Ltd. Partnership v. Wells Fargo Bank, N.A.*, 400 Md. 718, 745-749 (2007) (finding guarantors under loan agreement fully liable for total amount of debt as result of violation of recourse carveout provisions in loan agreement regarding misapplication of rents and failure to maintain SPE status); *Heller Fin., Inc. v. Whitemark at Fox Glen, Ltd.* (not reported in F. Supp. 2d) 2004 WL 2124942 (N.D. Ill., Sept. 21, 2004), at *5 (enforcing carveout in nonrecourse loan where borrower "misappropriate[ed] funds derived from the property" based on unauthorized transfers of accounts receivable to borrower's affiliates, thereby making borrower personally liable for amounts so transferred); *Vista Dev. Joint Venture II v. Pacific Mut. Life Ins. Co.*, 822 S.W. 2d 305, 307-08 (Tex. App. – Houston [1st Dist.] 1992, *writ denied*) (enforcing nonrecourse loan carveout for borrower's failure to pay real estate taxes, even though lender paid taxes after its foreclosure purchase of the property); *BW Village, Ltd. v. Tricon Enters., Inc.*, 879 S.W.2d 205, 208-09 (Tex. App. – Houston [14 Dist.]1994) (enforcing nonrecourse loan carveout for borrower's failure to pay real estate taxes, where lender purchased personal judgments against borrower obtained from taxing authorities for unpaid taxes). *Cf. Acorn Properties, Inc v. East 7th Realty Assoc.*, 656 N.Y.S.2d 274, 274 (1997) (affirming order denying lender's claim for deficiency judgment based on alleged violation of exception to nonrecourse provision in mortgage for fraud in procuring mortgage and waste of secured property, where lender's claim was untimely and lender had not presented evidence of alleged violations during foreclosure proceeding or in its motion for deficiency judgment). *See also* Jay Zagoren, Izabela E. Boltryk, and Kenneth D. Hackman, *Testing the Limits of Recourse Carve-Out Guaranties*, DECHERT ON POINT, Nov. 2009, Issue 29 (discussing *Blue Hills*, *infra* note 10, and other recent decisions regarding enforcement of carveout provisions in mortgage loan documents, and noting that while the published decisions have "consistently protected lenders," recent cases have "not expand[ed] the scope of recourse carveouts to bad acts not expressly covered by the agreement").

8. Some courts have held that the borrower may be personally liable for deliberately failing to take actions to preserve the value of the property, even where the loan is nonrecourse and contains no carveouts. The trend in recent case law has been to blur the

distinction between "intentional" (or "active") waste and "permissive" (or "passive") waste of mortgaged property, and to hold that in addition to physical waste, "economic" waste -- i.e., the failure to pay real property taxes or insurance premiums, or the diversion of misapplication of rents -- may be actionable as a violation of the mortgagor's contractual covenant in the mortgage not to commit waste or impair the value of the secured property. Some courts have even found the mortgagor personally liable under a tort theory of "bad faith" waste, in those situations where the loan documents contractually exculpate the mortgagor from personal liability for any default. *Nippon Credit Bank, Ltd. v. 1333 North California Boulevard*, 86 Cal. App. 4th 486, 496-97 (2001) (upholding jury verdict that found defendant-mortgagor, a California limited partnership, guilty of bad-faith waste for failure to pay real estate taxes while nonrecourse mortgage loan it had obtained from lender bank was delinquent); *Travelers Ins. Co. v. 633 Third Associates*, 14 F.3d 114, 120, 123 (2nd Cir. 1994). (ruling that mortgagor's deliberate failure to pay taxes on nonrecourse loan from available property income would permit action by mortgagee, under state's fraudulent conveyance statute, to set aside distribution of cash to mortgagor's partners as waste of mortgage security); *First Nat'l Bank v. Dual*, 15 Alaska 542, 545 (D. Alaska 1955 (holding that failure to pay insurance premiums can constitute waste); *D.A.N. Joint Venture v. Binafard*, 116 Fed. Appx. 93, 95 (9th Cir. 2004) (not published in Federal Reporter) (ruling that nonrecourse provisions in first deed of trust did not bar mortgagee's bad-faith waste action where mortgagors, despite substantial income from building, failed to meet obligation to maintain property and failed to preserve value of building).

But see Bank of America Illinois. v. 203 N. LaSalle N. LaSalle Street Partnership, 195 B.R. 692, 703 (N.D. Ill. 1996) (acknowledging that "[c]ourts have found that nonpayment of taxes constitute[s] waste where such payment is continuous and resulted in repayment of such taxes by the principal creditor," but holding that that in this case there was no continuous practice of nonpayment of real estate taxes by debtor and no indication of general course of conduct prejudicial to creditors, and that that neither mortgagee or property were injured in any way by delay in payment); *FGH Realty Credit Corp. v. Bonati*, 226 A.D. 2d 188-89 (N.Y. App. Div. 1st Dep't 1996) (holding that although banks, as holders of escrowed funds designated for payment of real estate taxes, could be held liable for breach of fiduciary duty for failure to pay taxes, non-escrow holding mortgagor who fails to pay real estate taxes does not thereby commit fraud within nonrecourse provision in mortgage; court distinguished *Travelers*, *supra*, finding that there was no evidence of fraud in this case that would support claim of waste of the property). *Cf. Boucher Investments, L.P. v. Annapolis West Ltd. Partnership*, 141 Md. App. 1, 21 (2002) (ruling that borrower's failure to secure off-site parking for mortgaged premises did not constitute waste because, as may be the case with respect to non-payment of property taxes or insurance premiums, such failure did not result "either in an increase of the debt or in an impairment of the security by subjecting it to liens superior to that of the mortgage" (quoting *Dick & Reuteman Co. v. Jem Realty Co.*, 225 Wis. 428, 435 (Wis. 1937)); *Aozora Bank, Ltd. v. 1333 N. Cal. Blvd.*, 119 Cal. App. 4th 1291, 1295-97 (2004) (holding that mortgagee could not recover attorney fees as costs as the prevailing party against mortgagor based on bad-faith waste claim in connection with nonrecourse loan (*see Nippon Credit Bank, Ltd. v. 1333 North California Boulevard*, *supra*) because loan documents provided that mortgagor was liable only "if and to the extent that" it "commits waste"; court reasoned that carve-out provision did not extend to liability for attorney's fees and did not impliedly include attorney's fees, as they are not generally awarded in tort actions for waste and parties may not recover attorney fees as costs unless a statute or contract provides otherwise; mortgagor pursued this decision against Aozora Bank, as successor to Nippon Bank, subsequent to the decision rendered in *Nippon Credit Bank, Ltd. v. 1333 North California Boulevard*, *supra*).

In an attempt to prevent the mortgagor from diverting property income to pay its equity holders in a nonrecourse loan, most commercial mortgage loan documents now contain a carveout stating that certain actions of the mortgagor, including the failure to apply rents to the maintenance of the property and servicing of the debt and the failure to pay real estate taxes when due, constitute actionable waste of the mortgage security notwithstanding the nonrecourse nature of the mortgagor's liability. Although the insertion of such contractual carveouts in the loan documents may have no direct bearing on a subsequent claim for tortious waste of the property based on nonpayment of taxes (as opposed to an action for breach of contract), the reason that mortgage lenders resort to tort theories in nonrecourse loans (where no contractual remedy may be available) is to force payment of the taxes that otherwise would have been paid from the property's revenue. The mortgagee's goal is generally not to punish the mortgagor, or risk aggravating courts of equity where the mortgagor has not engaged in any "bad acts." A recourse carveout for nonpayment of taxes has a powerful prophylactic effect -- rarely is there litigation involving a mortgagor's failure to pay taxes where the mortgage makes the mortgagor personally liable for such nonpayment -- and will, along with such cases as *Nippon* and *Travelers*, supra, undoubtedly have a "chilling" effect on mortgagors who may contemplate willfully failing to pay property taxes in order to divert funds to equity holders or attempt to obtain leverage to force a loan workout. *See* John C. Murray, *Nonpayment of Taxes as Tortious Waste in Nonrecourse Mortgage Loans*, 19 CAL. REAL PROP. J. 22 (2001); *Right of Mortgagee to Maintain Suit to Stay Waste*, 48 A.L.R. 1156 (as supplemented); Gregory M. Stein, *When Can a Nonrecourse Lender Reach the Personal Assets of its Borrower?* 17 No. 2 PRAC. REAL EST. LAW. 3 (2001).

9. The lender must be realistic in the assessment of its ability to recover against the borrower if the borrower becomes personally liable as the result of the breach of a nonrecourse carveout. For example, the right to assert recourse liability against a single-purpose, bankruptcy-remote entity such as a limited liability company, business trust, thinly capitalized corporation, or a limited partnership with a single-member limited liability company as the general partner, may be virtually worthless.

10. In *Blue Hills Office Park, LLC v. J.P. Morgan Chase Bank*, 477 F. Supp. 366 (D. Mass. 2007) (which may be the first reported decision in which a court has enforced recourse of "bad boy" carveouts in a nonrecourse securitized loan), the court held that when the borrower settled a zoning appeal -- in this case for $2 million – and failed to disclose the settlement to the lender or seek its consent (as required by the mortgage loan documents) and diverted the funds to itself, the borrower (and the guarantors) would be liable for the full amount of the loan ($17.5 million), and not simply the restitution

amount of $2 million. (The high bidder at the lender's foreclosure sale, instituted after the borrower defaulted on its loan payments, was a single-purpose entity created by the lender, which later sold the property to a third party.)

The court ruled that the settlement was part of the "mortgaged property," which, as described in the loan documents, included "Awards or payments . . . with respect to the Premises . . . for any . . . injury to or decrease in value of the Premises." The nonrecourse provision in the mortgage (which obviously was carefully negotiated) specifically provided that if the borrower diverted funds from the mortgaged property that belonged to the lender, the borrower's and guarantors' liability would become recourse for the entire loan balance (certain other borrower acts and defaults, such as fraud, intentional physical waste, or removal and disposal of mortgaged property after default, would result only in limited liability of the mortgagor and guarantors for actual damages).

The court castigated the attorneys for the borrower and the guarantors. Apparently these attorneys assumed that since litigation in this area is so rare, they could assume a very aggressive litigation posture and the matter would be worked out later to their satisfaction. But the moral (as indicated in the title of this article) is that carveouts to nonrecourse loans mean what they say and will be strictly enforced (even if the borrower and guarantors rely on advice to the contrary from their counsel)! After the court's judgment, the guarantors fired their attorneys and put them on notice of a malpractice claim. The borrowers and guarantors subsequently appealed from the judgment, but the appeal was dismissed and $17.25 million (98.5% of the judgment) was paid to the lender to settle the case. (*Blue Hills* Settlement and Release Agreement.) As Judge Young so succinctly stated during the trial, "don't mess around with the collateral. . . . "[I]f you mess around with the collateral, that's when you'll be liable for the entire amount of the deficiency." 10/13/06 *Blue Hills* Case Trial Transcript at 47.

The court also found a second violation of the nonrecourse carveouts – the borrower had violated single-member and single-purpose-entity requirements in the loan documents by commingling the $2 million settlement payment with monies of its member and by failing to maintain a participating independent director. Although the borrower had named as the "independent director" an individual who once worked as a paralegal or secretary at the borrower's law firm, the court stated that "it is clear that she did not participate in the management of Blue Hills in that capacity," *Id.* at 383, and that she "was not involved in the discussions concerning the $2,000,000 settlement payment." *Id.* Therefore, the court held, the borrower had violated a specific mortgage covenant because it had failed to "cause there to be" an independent director and had failed to maintain its status as a single-purpose entity.

The court in *Blue Hills* summarily rejected the borrower's lender liability claims (alleging that the special servicer had wrongfully denied its request to access reserve accounts to make the loan payments and real estate tax payments, and that the lender had breached the "implied covenant of good faith and fair dealing" by failing to meet with the borrower in an effort to work out the loan). The court held that the lender was perfectly within its rights in failing to meet with the lender after the occurrence of an acknowledged loan default and was under no obligation to transfer funds from special reserve accounts to make scheduled payments of principal and interest on the loan.

See also In re Kingston Square Associates, 214 B.R. 713, 721 (Bankr. S.D.N.Y. 1997) (finding for plaintiffs partially on basis that "[the "independent director"] seems not to have taken any interest at all in the properties. He testified that as a director he never reviewed any documents regarding any of the Debtors including rent rolls, judgments, or state court decisions"); *LaSalle Bank N.A. v. Mobile Hotel Properties, LLC*, 367 F. Supp. 2d 1022, 1029-31 (E.D. La. 2004) (ruling that carveout provision in nonrecourse mortgage providing that debt would become fully recourse to borrower and guarantor if borrower failed to maintain its status as single purpose entity was triggered by borrower's amendment of its limited liability company Articles of Organization, without lender's knowledge or consent, to provide that borrower could engage in other activities, thereby making mortgage a full-recourse obligation).

11. In a more recent case, *CSFB 2001–CP–4 Princeton Park v. SB Rental 1, LLC*, 410 N.J. Super. 114 (2009), the mortgage note contained a non-recourse provision, which precluded the lender from seeking recovery against either the borrowing entity or its principals (as guarantors) if a loan default occurred. But the note also contained a carve-out clause stating that the debt would be fully recourse if certain acts occurred; including failure to obtain the lender's prior written consent to any subordinate financing encumbering the property. (The guaranty executed in connection with the loan held the principals-guarantors liable to the same extent as the borrower). The court found that the borrower subsequently violated this specific carveout by obtaining subordinate financing in the amount of $400,000 and permitting a second mortgage on the property to a third-party lender without first obtaining the first mortgagee's consent. According to the appellate court:

> In so doing, the borrower triggered the non-recourse carve-out provision of the loan documents, rendering the loan fully recourse as to the [borrower] and the guarantors. However, the [second] mortgage was paid off in full seven months later, in December 2004, and was therefore terminated, although [the second mortgagee] neglected to timely discharge the obligation. In any event, eighteen months later, in May 2006, [the borrower] failed to make its monthly mortgage payment to CSFB, presumably because of the loss of its sole tenant and rental income stream, and has not made any principal or interest payments since then.

Id. at 118.

The trial court (and the appellate court) rejected the borrower's argument that the non-recourse carve-out clause was an unenforceable penalty because the first mortgagee was not harmed by the second mortgage and the breach was unrelated to any damages suffered by first mortgagee. According to the appellate court:

> The motion judge disagreed, finding that the damages sought by plaintiff were neither speculative nor estimated,

> but actual, ("equal to the outstanding loan balance and nothing more") and fair, ("[t]he defendants hav[ing] received the benefit of their bargain by receiving and retaining the loan proceeds"). Concluding that the disputed provision addresses liability rather than damages, the judge emphasized the business sophistication of defendants, who acted with full knowledge and understanding of the carve-out position:
>
>> These are sophisticated defendants that were dealing at arms length when they signed the absolute and unconditional guarantee to govern the instances in which recourse liability would be triggered. The parties understood the provisions, and how they would operate, when they entered into the agreement, as they bargained for the opportunity to avoid recourse liability in certain instances, yet engaged in conduct that they knew would implicate personal liability if discovered.
>
> On appeal, defendants mainly argue, as they did below, that the non-recourse carve-out clause is unenforceable as a liquidated damages provision because the penalty extracted from the borrower's breach of a covenant not to further encumber the mortgaged property bears no reasonable relationship to any harm suffered by the lender. This argument fails.

Id. at *119.

The appellate court further stated that:

> Here, there is no dispute that the loan made by plaintiff to SB Rental is a non-recourse loan, excluding the borrower and guarantors from personal liability for the remaining debt upon default and leaving the creditor's recourse solely to repossession of the property given as security for the loan. The loan documents, however, expressly carve out from this exemption certain breaches that implicate personal liability, including the failure to obtain the lender's consent to any subordinate financing or other lien encumbering the mortgaged property. This is unambiguous language. Further, this was a commercial transaction negotiated between business entities with comparable bargaining power. The parties knew and agreed to the carve-out of the non-recourse loan, which, because it

> affects the value of the collateral, was a material term in acquiring the $13 million loan. Where, as here, sophisticated parties agree to carefully crafted terms, they should be held to the plain and clear language they chose.

Id. at 120.

With respect to the debtors' "liquidated damages" argument, the appellate court stated that:

> Non-recourse carve-out clauses like the one here are not considered liquidated damages provisions because they operate principally to define the terms and conditions of personal liability, and not to affix probable damages. Generally speaking, because non-recourse loans may create issues of a borrower's motivation to act in the best interest of the lender and the lender's collateral, "lenders identified defaults that posed special risks and carved them out of the general nonrecourse provision." Portia Owen Morrison and Mark A. Senn, *Carving Up the 'Carve-Outs' in Nonrecourse Loans*, 9 PROB. & PROP. 8 (1995). These carve-outs, which are perceived to affect the value of the collateral that secures the loan, afford the lender the protection required by causing the debtor and any guarantors to be personally liable, thus enabling the creditor to look beyond simply the mortgaged property for repayment of the loan. In other words, whereas the non-recourse nature of the loan operates as an exemption, the carve-outs exist to implicate personal liability.
>
> The carve-out clause is not a liquidated damages provision for yet another reason: it provides for only actual damages. Unlike the typical stipulated damages provision which reasonably estimates an amount otherwise difficult to compute, the carve-out clause permits the lender to recover only damages actually sustained, namely the amount remaining on the loan at the time of breach. Such an amount is fixed by the terms of the loan and is therefore neither speculative nor incalculable. As noted, this action involves a loan made by plaintiff to SB Rental, who, along with the guarantors, agreed to its repayment, having received the full benefit of the contract. Plaintiff, in turn, made the loan with the assurance of full repayment. In filing this lawsuit, plaintiff simply seeks the amount left on the loan at the time of ultimate default. This amount is the actual damage to plaintiff based on defendants' failure to

> make mortgage payments. Since the carve-out clause imposes personal liability for plaintiff's actual damages, it is not a liquidated damages provision, much less an unconscionable penalty.

Id. at *121-122.

Finally, the court also rejected the borrower’s argument that since the breach that triggered personal liability was eventually cured, resulting in no harm to first mortgagee, enforcement of the carve-out here was unfair and unjust. The court stated that:

> It matters not, as defendants argue, that they eventually cured the very breach that triggered their personal liability and that no harm accrued to plaintiff as a result thereof.
>
> . . . .
>
> [H]ere, the fact that the subordinate financing was paid off well before defendants' ultimate default on payment of the principal loan does not alter the fact that defendants breached the very obligation identified by both parties as posing a special risk to plaintiff, and therefore requiring the covenant's special protection. By further encumbering the property, even if only temporarily, defendants' action had the potential to affect the viability and value of the collateral that secured the original loan. Indeed, it cannot be said with any certainty that the subordinate financing in this case was entirely unrelated to defendants' ultimate default on their mortgage payments. In any event, the fact that such potential may not have actualized does not diminish the breach of obligation nor vitiate its contracted-for consequences. Having freely and knowingly negotiated for the benefit of avoiding recourse liability generally, and agreeing to the burden of full recourse liability in certain specified circumstances, defendants may not now escape the consequences of their bargain.

Id. at 123-124.

In support of its holding, the appellate court cited the *Brookhaven* and *Prince George* cases (see 6., *supra*), among others, in its opinion. As noted in 6., *supra*, both of these cases upheld the validity and enforceability of a non-recourse carveout for a bankruptcy filing by the borrower (at least in those cases where the borrower’s bankruptcy proceeding had been terminated). The court also cited (with approval) and discussed the *Blue Hills* decision (see 10., *supra*) in support of its holding.

11. *But see ING Real Estate Finance (USA) LLC v. Park Avenue Hotel Acquisition LLC*, 2010 WL 653972 (N.Y. Sup. Feb 24, 2010). In this case, the court refused to enforce a non-recourse carveout provision in the loan documents that would have made the guarantors fully liable for the debt. The plaintiff, ING Real Estate Finance (USA) LLC ("ING"), argued that the defendant borrower and guarantors violated the terms of a "Full Recourse Event" clause contained in the Credit Agreement executed by the borrower, because of the failure to pay real estate taxes due in the amount of $278,759.20, which resulted in a tax lien against the property. The court framed the issue in this case in the following manner:

> The question before the Court is whether, by the terms of the contract, the nineteen-day tardiness in paying less than $300,000 in property taxes triggers a full recourse obligation by the Guarantors of up to $90 million. The parties cite separate, facially inconsistent, provisions of the contract in support of their respective positions.

Id. at *3.

The court found that one of the provisions in the Credit Agreement, which explicitly provided for a thirty-day grace period upon the filing of a lien before recourse could arise (the delinquent taxes were paid in full six days after ING amended its complaint to include the guarantors, well before the expiration of the one-year period during which the city of New York could institute a foreclosure action for unpaid taxes), was the controlling provision in this case. ING argued that another provision in the Credit Agreement, the "Full Recourse" provision, provided for full and immediate recourse liability of the guarantors if the borrowers incurred any "Indebtedness" (as defined in the Credit Agreement to include "obligations secured by any Liens, whether or not the obligations have been assumed"). ING asserted that the borrower's failure to timely pay the real-estate taxes was a Full Recourse Event under the Credit Agreement, and that the Guaranty Agreement executed by the guarantors concurrently with the Credit Agreement provided that the guarantors' full liability would be triggered in the event of the occurrence of such a Full Recourse Event. The court reasoned that where a document contains conflicting or contradictory language, "specific provisions control over general provisions." *Id.* at *4 (internal quotations and citation omitted). The court deemed the provision providing the cure period to be the more specific provision because otherwise other provisions of the Credit Agreement would be read out of the Credit Agreement or rendered meaningless (such as the provision entitling the borrower to contest any tax lien) . The court also noted that under New York law, the terms of a guaranty are to be strictly construed in favor of the guarantor(s). The court in effect applied a liquidated-damages analysis to this issue, stating as follows:

> Immediate liability for the entire debt is not a reasonable measure of any probable loss associated with the delinquent payment of a relatively small amount of taxes. Here, pursuant to Section 9.3(d) [of the Credit Agreement], plaintiffs would have moving defendants potentially liable for the entire debt of up to $145 million if the Borrower is just one day

> delinquent in paying a dollar in property taxes or any other debt for which a lien may be imposed. Such an unlikely outcome could not have been intended by the parties, sophisticated commercial borrowers and lenders aided by competent counsel at the time of the drafting, and is impermissible under New York law.

Id. at *5.

This case appears to be an isolated decision with bad facts, and unusual in that the court acknowledged that this was a commercial transaction in which all parties were sophisticated and represented by competent counsel. The court struggled to reconcile the conflicting non-recourse and carveout provisions in the Credit Agreement, and most likely favored the guarantors in this case because the events allegedly triggering full recourse liability were of little consequence, of short duration, and did not adversely affect the interests of the lender, whereas the consequences to the guarantors were extreme and not reasonably related to the lender's actual or anticipated damages under a liquidated-damages analysis. It will be interesting to see if any other courts follow this line of reasoning. For an excellent discussion of this case, *see* Prof. Patrick Randolph's *Daily Development for Wednesday, April 27, 2010*, on the DIRT internet discussion group for real estate professionals, available at dirt@umkc.edu.

12. The court in the *Blue Hills* decision (see 10., *supra*) endorsed an expansive definition of "mortgaged property," as broadly defined in the mortgage's granting clauses, to include non-real estate assets only indirectly related to the mortgaged real estate, i.e., a lawsuit brought by the borrower and its settlement proceeds. But might this type of action also be characterized, under somewhat similar circumstances, as a security interest in a tort claim under Article 9 of the Uniform Commercial Code ("UCC")? Could there be a potential conflict? *See* Prof. Daniel Schecter, *Proceeds Resulting from Settlement of Zoning Appeal Are Part of Mortgaged Property and Belong to Mortgage Lender. [Blue Hills Office Park LLC vs. J.P. Morgan Chase Bank,* 2007 COMM. FIN. NEWSComm. Fin. 26 (April 2, 2007) (Comment):

> I wonder whether under a different set of facts, the characterization of the settlement proceeds as "mortgaged property" might create a potential priority conflict with Article 9 of the UCC, which (under some circumstances) permits secured parties to take security interests in commercial tort claims. Suppose, for example, that a borrower's shopping center is injured because a neighboring entity is emitting unpleasant odors thus constituting a nuisance. If the borrower brings a suit against the neighbor on a nuisance theory, that tort recovery might belong to the Article 9 lender with a security interest in the borrower's commercial tort claims. At the same time, the same recovery might be characterizable as part of the "mortgaged property" belonging to the mortgage lender. (Even if there were a potential conflict, the best solution

> would be a timely intercreditor agreement between the two lenders.)

The issue may well be the distinction between the grant of a security interest and the perfection of the security interest in the collateral. The granting clause in a mortgage may be sufficient for attachment as meeting the security interest requirement of §9-203(b)(3)(A) of the UCC. But the filing of a mortgage cannot perfect a security interest in personal property other than fixtures. For example, the granting clause in a mortgage could not define trucks located on the property as "mortgaged property," then try to perfect a security interest in certificated goods through recordation of the mortgage. The correct reasoning undoubtedly is that "mortgaged property" must ultimately be actual real property (or fixtures). A UCC filing clearly would be necessary where a mortgage loan is secured by equipment, personalty or contract rights. Although a mortgage that also constitutes a fixture filing will create and perfect a valid security interest in the fixtures, there is a chance that what the secured party believes are "fixtures" are in fact just equipment. Section 9-102(a)(4) of the UCC (which defines fixtures) should be studied carefully. If the described collateral is not in fact "fixtures," then a fixture filing -- or a mortgage that serves as a fixture filing -- will not perfect a security interest in the collateral. Comment 6 to UCC §9-503 states, in part:

> In some cases, it may be difficult to determine whether goods are or will become fixtures. Nothing in this Part prohibits the filing of a "precautionary" fixture filing, which would provide protection in the event goods are determined to be fixtures. The fact of filing should not be a factor in the determining whether goods are fixtures.

Therefore, when in doubt it may make sense for the secured party to take the conservative approach and also file a regular UCC financing statement in the "location" of the debtor, with a description of any collateral that may potentially be deemed to be personal property. For example, insurance and condemnation proceeds (as opposed to fixtures, which are defined under applicable state law) with respect to real property that are payable in accordance with a specific provision in the mortgage, probably are not covered by the UCC. On the other hand, insurance and condemnation proceeds paid with respect to fixtures could be "proceeds" of the fixtures and therefore constitute covered UCC collateral under Article 9. (However, a standard mortgagee clause may give the lender a direct contractual right against the insurance company rather than a lien on money payable to the borrower. In that situation, the lender's right to receive the insurance proceeds probably is not a security interest that needs to be perfected under the UCC.)

When the collateral is in fact a commercial tort claim, special rules apply: under Section 9-108(e)(1) of the UCC, a description only by type of collateral defined in the UCC is not sufficient to identify a commercial tort claim, and, under Section 9-204(b)(2), a security interest cannot attach to a commercial tort claim under an after-acquired property clause. The combined effect of these provisions is that a security interest cannot be created in a commercial tort claim that does not yet exist, and the security agreement must describe the claim with sufficient detail in order for a security interest to attach. (See Official Comment 5 to Section 9-108: the description doesn't have to be specific--it need not specify the amount of the claim, the theory on which it may be based, or the identity of the tortfeasor(s), for example--but it should reasonably identify an existing claim. The Official Comment gives, as an example of a sufficient description: "all tort claims arising out of the explosion of the debtor's factory.")*

*The information in this paragraph was supplied to the author by Jerome Grossman, a partner with the law firm of Luce, Forman, Hamilton & Scripps, LLP.