PUBLICATION

Non-Recourse Provisions in Loans - Beware Those Carve-Outs!

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The borrower in negotiating a commercial loan may be able to negotiate a nonrecourse loan for the borrower and/or guarantors. With a non-recourse loan, the lender agrees that the borrower and/or guarantor will not be personally liable on the loan and the lender will look solely to the collateral that has been provided as security for the loan, generally real estate, in the event of a default. Typically, however, the lender will have specific carve-outs for "bad acts." A listing of such carve-outs may be quite extensive running the gamut of misapplication of insurance proceeds to intentional destruction or waste of the property. For borrowers and guarantors, it is important to review and consider every aspect of these provisions. No only may the carve-outs be quite broad, but also the terms may make a borrower and any guarantors fully liable for the loan if one of these "bad acts" occurs.

This situation is illustrated in the recent case of *Blue Hills Office Park v. J.P. Morgan Bank*, 477 F. Supp. 2d 366 (D. Mass. 2007). In 1999, Blue Hills Office Park LLC (Blue Hills) obtained a $33,149,000 commercial non-recourse loan from Credit Suisse secured by a mortgage on real property which loan was ultimately assigned to J.P. Morgan. In 2003, Blue Hills obtained $2 million from a settlement agreement pertaining to a zoning dispute. J.P. Morgan was never notified of this payment nor was the payment delivered to the lender.

After a major tenant left in 2004, Blue Hills was unable to pay taxes, principal or interest on the loan. J.P. Morgan assigned the loan to another entity who foreclosed on the real property. In April 2005, the lender sought a full deficiency on the loan under the provisions of the guaranty. The guarantors failed to make payment and litigation ensued.

The mortgage had provided at paragraph 10(a) the following: "Mortgagor shall not, without the prior written consent of the mortgagee or as otherwise expressly provided herein or in the other Loan Documents, sell, convey, alienage, mortgage, encumber, pledge or otherwise transfer the Mortgaged Property or any part thereof, or permit the Mortgaged Property or any part thereof to be sold, conveyed, alienaged, mortgaged, encumbered, pledged or otherwise transferred." Id. at 377. The promissory note which contained the non-recourse provision stated that "the Debt shall be fully recourse to the Maker in the event that ….(iv) Maker fails to obtain Payee's prior written consent to any assignment, transfer, or conveyance of the Mortgaged Property or any interest therein if required by [paragraph] 10 of the Mortgage…" Id. at 378.

The defendants argued that the settlement payment was not part of the definition of "mortgaged property," and that the term referred only to real estate. However, the terms of the agreement defined "mortgaged property" to include "any portion of the Mortgaged Property and any interest therein." Furthermore, aside from this language, the court reasoned that since the loan is non-recourse, the lender looks entirely to the value of the mortgaged property and to merely protect the real estate itself from transfer would not fully protect the lender since the lender relies on this property as the source of its repayment. Thus the court held that the zoning appeal was included in the definition of "mortgaged property" as the cause of action derived from the borrower's ownership of the real estate. The $2 million settlement received was also a part of the "mortgaged property."

In determining whether the guarantors were fully liable for the amount of the deficiency, the court considered the wording of the second paragraph of Section 1.2 of the guaranty which stated: "[g]uarantor shall be liable for the full amount of the Debt in the event [the]…(D) Borrower fails to obtain Lender's prior written consent to any assignment, transfer, or conveyance of the Mortgaged Property or any interest therein if required by Section 10 of the Mortgage." The guarantors, however, argued that the first paragraph of Section 1.2 provides for limited liability tied to loss, damage or expense that was incurred by lender for the occurrence of certain enumerated events, and borrower's actions fell within the area of limited liability. Alternatively, the guarantors argued that the limitations of liability in the first paragraph should apply to the provisions of the second paragraph.

The court was not persuaded by either argument. The wording of the second paragraph of guaranty itself made clear that the guarantor would be fully liable for the full amount of the debt for certain enumerated events. Since the lender could only look to the mortgaged property for repayment, this paragraph served as an incentive to the guarantors to maintain the value of the property and to seek the permission of the lender prior to doing anything with the mortgaged property. Thus the guarantors were fully liable for the deficiency of more than $10.7 million, not just the $2 million the borrower failed to deliver to the lender.

This case demonstrates the need for borrowers and guarantors to carefully evaluate non-recourse provisions of their contracts at the time of signing the loan documents. In any case where there is a list of exceptions to the non-recourse provision, the borrower would want to make sure that liability is limited to the amount of the funds misapplied and that any personal liability arising by virtue of the actions/omissions enumerated in the exceptions are limited to the amount of loss, cost, damage and expense incurred by the lender as a result the borrower's actions and/or omissions as described in the exceptions. In addition, it might be prudent for the borrower to negotiate provisions limiting personal liability against any guarantors and against the principals of the borrower such as the members of borrower which is a limited liability company or general or limited partners of a borrower which is a limited or general partnership.

Borrowers and guarantors should carefully evaluate their actions during the term of the loan to ascertain if any of their actions might fall within the exceptions to the nonrecourse provisions. Seemingly innocuous actions may expose a borrower and guarantors to liability which could be significant, especially where the borrower was not successful in negotiating limitations to the carveouts in the loan documents.

Also, keep in mind, if the borrower sells the property and the lender allows an assumption of the loan, the borrower will want to negotiate a release from liability for himself and the guarantors. The successor borrower may engage in activities that may possibly negate the non-recourse provisions of the loan, thus exposing the original borrower and original guarantors to liability. Since the original borrower will normally have little or no control over the new borrower and his activities respecting the property, a release is essential.