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Full Recourse Enforcement of Non-Recourse Loans

A Look at Cherryland *and* Chesterfield

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Two recent cases from Michigan could have far-reaching implications nationwide regarding the enforceability of non-recourse loans as fully recourse. Indeed, if the decisions in *Wells Fargo Bank, N.A. v. Cherryland Mall Limited Partnership*, 2011 WL 6785393 (Mich. App., Dec, 27, 2011) and *51382 Gratiot Avenue Holdings, LLC v. Chesterfield Development Company, LLC, et al.*, 2011 WL 6153023 (E.D.Mich., Dec. 12, 2011) are accepted in jurisdictions outside of Michigan, many non-recourse CMBS loans could very well be converted to recourse simply because a special purpose entity (SPE) requirement, such as insolvency by the borrower, has been breached. And guarantors, as a result, could face a flood of deficiency claims in respect to loans they believed to be non-recourse. Needless to say, CMBS lenders, borrowers and guarantors should take the time to understand the issues raised in these two Michigan cases.

Background on CMBS Transactions

Generally speaking, the CMBS market brought non-recourse, asset-specific financing for commercial real estate to the capital markets. New and varied lending sources could now access commercial real estate in the capital markets and, in exchange, property owners could more easily acquire and finance real estate without putting their personal balance sheets at risk. In its simplest form, a lender would make a number of disparate mortgage loans to unrelated entities, then deposit each of the loans into a trust that would issue securities to the public or private markets backed by the cash flow from the mortgage payments and the underlying real property securing each of the loans. "Asset isolation" — with its twin components of separateness covenants and narrow limitations on a lender's agreement not to pursue recourse liability — allows CMBS loans to be made on a non-recourse basis.

The *Cherryland* Decision

The Court of Appeals for the State of Michigan recently upheld a judgment awarding Wells Fargo Bank over $2 million on a mortgage deficiency claim against Cherryland (the Borrower) and David Schostak (the Guarantor and together with the Borrower, the Defendants), even though the loan was non-recourse. The appellate court found that the loan documents at issue provided for full recourse against the Defendants upon the failure of the Borrower to maintain certain loan covenants, including the Borrower's solvency, which failure resulted in the revocation of SPE status. Because there was no question that the Borrower was insolvent, the recourse provision in the loan documents was triggered and Wells Fargo could seek the mortgage deficiency claim from the Defendants. The facts of the case follow.

In 2002, Cherryland obtained an $8.7 million mortgage loan (the Loan), which was later transferred to Wells Fargo. from Archon Financial, LP. The Loan was collateralized by the underlying property evidenced by a traditional CMBS mortgage (the Mortgage), note, assignment, and guaranty of recourse obligations (collectively, the Loan Documents). Wells Fargo subsequently transferred the Loan to a real estate mortgage investment conduit trust, for which Wells Fargo was the trustee. Section 9 of the Mortgage, entitled Single Purpose

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Entity/Separateness," provided a list of CMBS market standard covenants that were incorporated into the other Loan Documents.

In 2009, Cherryland failed to make its Loan payment and Wells Fargo ultimately commenced and conducted a sheriff's sale of the collateral. Wells Fargo was the successful bidder at the sale with a bid of $6 million, leaving a deficiency claim on the Loan of approximately $2.1 million. Immediately after the sale, Wells Fargo initiated litigation seeking to enforce the Loan Documents to collect from the Borrower on the deficiency claim. Wells Fargo eventually filed an amended complaint, naming the Guarantor on the theory that the Borrower's insolvency constituted a failure to maintain its SPE status, thereby triggering the recourse provisions in the Mortgage. The trial court ultimately found that the Borrower's insolvency did indeed constitute a failure to maintain SPE status thereby triggering the recourse provisions in the Mortgage, and allowing Wells Fargo to seek the deficiency claim from the Defendants.

On appeal, the Defendants first argued that once the Loan was foreclosed, the terms and conditions of the Mortgage were extinguished, thereby barring Wells Fargo's lawsuit. While the Appellate Court agreed that, generally speaking, a foreclosure extinguishes a mortgage, and that mortgages in Michigan are non-recourse absent an agreement to the contrary, the Appellate Court found that the Loan Documents contained a recourse provision, and reasoned that under Michigan law, a recourse provision entitles a lender to collect on a deficiency either through the foreclosure process or as a separate action after the foreclosure process. Thus, even though the Mortgage had indeed been extinguished, the Appellate Court found that the terms of the note entitled Wells Fargo to maintain the suit.

Defendants next argued that: 1) the Loan was unambiguously non-recourse and that insolvency was not a violation of Borrower's SPE status or, alternatively; 2) the Mortgage was in fact ambiguous and that extrinsic evidence established that solvency was not required to maintain SPE status. The appellate court found that the dispute involved a simple matter of contract interpretation, as the Loan Documents all provided that the Loan became fully recourse as to the Borrower and Guarantor in the event that the Borrower failed to maintain its SPE status as required by, and in accordance with, the terms and provisions of the Mortgage. In essence, the dispute turned on whether failure to adhere to the SPE requirements of Section 9 of the Mortgage resulted in a revocation of SPE status. Wells Fargo argued that the Borrower became insolvent — one of the 15 enumerated SPE/separateness covenants — and, therefore, the Borrower's SPE status was revoked, thereby triggering full recourse against the Defendants. The Borrower argued that adherence to the insolvency SPE covenant was not, in fact, a requirement to maintain its SPE status.

In an effort to show that the Loan Documents were ambiguous, Defendants first noted that the Mortgage did not define the term "single purpose entity" and, therefore, there were no SPE "covenants" to speak of. The Appellate Court found that the failure to define "single purpose entity" did not render the contract ambiguous where the contractual term was a technical term used in the industry and parole evidence could be used to define the term. Next, the Appellate Court reviewed the S&P's U.S. CMBS Legal and Structured Finance Criteria for the definition of "single purpose entity" and determined that nothing in the definition suggested that the list of SPE/separateness requirements in section 9 are not required to maintain SPE status. In addition, the Appellate Court observed that it was less likely that there were no SPE covenants and only separateness covenants and more likely that separateness was a component part of SPE, such that SPE status is maintained when abiding by the separateness covenants. Viewed in this light, "single purpose entity" and "separateness" are two distinct concepts that are integrally intertwined.

Defendants then made highly technical contract interpretation arguments as to why the separateness covenants were not necessary to maintain SPE status. First, Defendants asserted that determining the boundaries of SPE status according to the section 9 "Single Purpose Entity/Separateness" heading violated the boilerplate provision that provides that headings and captions are for convenience purposes only and in no way are intended to limit or otherwise define the scope or content of the applicable provisions. The Appellate Court, however, found that a more reasonable approach was simply to look at the mortgage and to find references to "single purpose entity." To ignore the section headings would, according to the appellate court, 1) lead to the conclusion that there was nothing the Defendants needed to do to maintain SPE status; and 2) render all of the sections in the Loan Documents that require the defendants to maintain SPE status superfluous in violation of the cardinal rule of contract construction that a court must give effect to every word, phrase, and clause in a contract and avoid an interpretation which would render any part of the contract surplusage or nugatory.

The appellate court then rejected the argument that no cases have held that a borrower's insolvency is a violation of SPE status, finding that several federal courts have held that the requirements in section 9 of the Mortgage are in fact SPE covenants that need to be maintained in order to avoid a revocation of SPE status. Finally, Defendants argued that because the solvency requirement was intended to prevent owners from removing assets from the borrower such that the borrower would not be able to pay its debts, and it was not intended to cover a situation outside of the borrower's control, the requirement was in fact not breached because no money was removed. The appellate court found that the requirement was simply to remain solvent, and how it became insolvent was irrelevant for purposes of the recourse trigger.

The *Chesterfield* Decision

In *Chesterfield*, decided two weeks before *Cherryland*, the United States District Court for the Eastern District of Michigan found that the lender was allowed to pursue recourse liability against the borrower and guarantor notwithstanding the non-recourse nature of the loan. Similar to the facts in *Cherryland*, Chesterfield, the borrower under a $17 million CMBS loan, stopped making the required monthly payments, resulting in a default. When Chesterfield was unable to pay the accelerated loan balance, the lender foreclosed on the property, which was sold at public auction for $7.6 million. Subsequently, the lender sought to recover a $12 million deficiency from the borrower and the guarantor. Unlike the loan documents in *Cherryland*, the *Chesterfield* loan documents clearly provided for full recourse against the guarantor if the borrower became insolvent or failed to pay its debts and liabilities from its assets. Because one of the non-recourse carve-out provisions in the note had in fact been triggered, the district court found that full recourse liability as against the borrower and guarantor had been triggered, and awarded a judgment in favor of the lender in excess of $12 million. The defendants' motion for reconsideration was denied.

Implications

The *Cherryland* and *Chesterfield* decisions are, as the *Cherryland* appellate court itself noted regarding its own interpretation, incongruent with the perceived nature of a nonrecourse debt. And while the *Cherryland* court acknowledged that its decision may in fact cause economic disaster for the business community in Michigan, if these two decisions are affirmed on appeal, borrowers and guarantors of non-recourse loans all across the country will have good reason to be concerned going forward. Whereas CMBS lenders, the beneficiaries of these decisions, now find themselves with another avenue for collection of loan deficiencies, guarantors, who probably never expected to be personally liable for such debt, could see a flood of deficiency claims heading their way.

In light of *Cherryland* and *Chesterfield*, and in order to avoid and protect against the issues raised therein, borrowers and guarantors should take the time to: 1) examine their current CMBS loan documentation to consider what actions, if any, need to be taken to protect their rights; 2) understand each of the non-recourse carve-outs present in their existing documentation and how they can be triggered (and take any and all steps necessary to avoid triggering them); and 3) carefully draft CMBS loan documentation going forward that contain clearly defined terms and provisions relating to SPE requirements, on the one hand, and the liability arising from the breach of those requirements, on the other.

For example, a guarantor's liability for a borrower's breach of a separateness covenant to remain solvent and/or adequately capitalized and/or to pay its own debts is different from that of a breach of a separateness covenant to use separate stationery or not commingle its funds with those of another person. A guarantor's liability for the former is in the nature of additional credit support for the loan, whereas its liability for the latter is intended to deter the borrower from taking certain "bad" action.

Because a borrower's insolvency can be triggered by events beyond the borrower's and the guarantor's control, as was the case in *Cherryland*, parties to a CMBS transaction should consider negotiating for carve out separateness covenants relating to solvency, capitalization and/or payment of debts from a recourse provision triggered by the borrower's breach of separateness covenants. Indeed, such carveouts have become common in recourse guarantees given to CMBS lenders. All we can do now is await the disposition of the appeals and react accordingly.