Non-Recourse Carve Outs, Bad-Boy Guaranties and Personal Liability

Strafford Webinar

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Purpose of Presentation

- The setting for litigating bad boy guaranties usually follows the following fact pattern.

- *After foreclosing on property securing the loan, the lender brings an action against the borrower and the guarantor to recover deficiency between the balance owed on the loan and the value of the foreclosed property.*

- The more difficult situation for attorneys arises in the following fact pattern:

- *On the advice of its legal counsel, the borrower on a $4.1 million mortgage loan filed for bankruptcy, exposing the guarantors to $100 million in personal liability. The attorney for the borrower advised the director/guarantor he had a fiduciary duty to file for bankruptcy even though it would trigger personal liability. The guarantors sued the attorney for legal malpractice, arguing the director would have been protected from a breach of fiduciary duty claim because he was exercising his business judgment.*

Case Summaries Relating to Bad Boy Guaranties
Cases Supporting Enforcement

51382 Gratiot Avenue Holdings, LLC v. Chesterfield Development Co., 835 F. Supp. 2d 384 (E.D. Mich. 2011) – After default by defendant on commercial mortgage, plaintiff foreclosed on shopping center. Plaintiff then filed suit against guarantor to recover the deficiency in the amount of $12,000,000. Promissory Note contained carve-out if borrower became insolvent or failed to pay its debts and liabilities. Nonpayment by the borrower triggered guarantors' personal liability. Court found no equitable reasons to deny personal liability. Guarantors were sophisticated parties who had the benefit of counsel. Defendant incurred full recourse liability when it violated a covenant contained in the mortgage. Plaintiff's agreement not to pursue recourse liability is rendered null and void.

Case Summaries Relating to Bad Boy Guaranties
Cases Supporting Enforcement

Heller Financial, Inc. v. Lee, 2002 WL 1888591 (N.D. Ill., August 16, 2002) – Nonrecourse loan contained several carve-outs implicating personal liability of guarantors. Plaintiff Heller contended that any lien placed on the property would cause guarantors to be personally liable on otherwise nonrecourse loan if additional encumbrances placed on property without consent of lender. Six liens (mechanic's liens and tax liens) were filed against the collateral. Defendants argued that springing guaranty is an invalid liquidated damages provision because it is an unenforceable penalty. Court ruled the carve-outs were not liquidated damages because it provided only for recovery of actual damages

Case Summaries Relating to Bad Boy Guaranties
Cases Supporting Enforcement

CSFB 2001-CP-4 Princeton Park Corporate Center, LLC v. SB Rental 1, LLC, 980 A. 2d 1 (N.J. Super. Ct. App. Div. 2009) – Court dealt with whether a non-recourse carve-out for failure to obtain lender's prior consent to subordinate financing encumbrances is a liquidated damages provision, and, if so, whether it constitutes an unenforceable penalty. Borrower argued an unenforceable penalty/liquidated damages because the first mortgagee was not harmed by second mortgage. Court ruled not liquidated damages because it did not fix the damage amount but merely defined the terms and conditions of personal liability, and because it provides only actual damages. *The later cure of the breach did not matter!*

Case Summaries Relating to Bad Boy Guaranties
Cases Supporting Enforcement

Wells Fargo Bank, N.A. v. Cherryland Mall Ltd. Partnership, 812 N.W. 2d 799 (Mich. Ct. App. 2011) – Securitized commercial real estate loan required borrower to maintain Single Purpose Entity ("SPE") status. Court ruled lender was entitled to enforce the SPE provision under which one covenant required the borrower to remain solvent even though no cases have held that insolvency is a violation of SPE status. Court applied strict construction principles and noted the loan documents were drafted by experienced and sophisticated parties.

Case Summaries Relating to Bad Boy Guaranties
Cases Supporting Enforcement

Cherryland II, 493 Mich. 859 (2012) – Court remanded case for re-consideration in light of Michigan's new Nonrecourse Mortgage Loan Act, which prohibits nonrecourse lenders from triggering carve-out guaranties based on borrower's mere insolvency. Supreme Court of Michigan did not think it wise to review balance of questions raised on appeal.

Case Summaries Relating to Bad Boy Guaranties
Cases Supporting Enforcement

Bank of America v. Freed, 983 N.E. 2d 509 (Ill. App. Ct. 2012) – Agreements contained a carve-out if the borrower/guarantors contested, delayed or hindered foreclosure. Defendants contested the foreclosure and appointment of a receiver. This triggered personal liability. Court rejected arguments this was a vague or ambiguous contract provision, an unenforceable penalty, liquidated damages, and a violation of due process rights. Guarantors could oppose the appointment of a receiver, but by taking those actions they forfeited their exemption from liability for full repayment of the loan.

Case Summaries Relating to Bad Boy Guaranties
Cases Supporting Enforcement

BrookhavenRealty Assocs., 637 N.Y.S. 2d 418 (1996) – A carve-out if borrower filed for bankruptcy and failed to dismiss his case within 90 days was upheld. Bankruptcy Code §365(e) does not apply because not a mortgage is not an executory contract. Case has good language regarding what actions a lender can take in the bankruptcy of borrower, which does not defeat the springing provisions in a guarantee.

Case Summaries Relating to Bad Boy Guaranties
Cases Supporting Enforcement

FDIC v. Prince George Corp., 58 F.2d 1041 (4th Cir. 1995) – FDIC is entitled to a deficiency judgment against defendant if a) it voluntarily becomes part of a case, action suit or proceeding which suspends, reduces or impairs FDIC's recourse rights to the collateral or if defendant engaged in any act, omission or misrepresentation that has the same effect. Court applied fundamental contract interpretations principles to determine whether filing bankruptcy and resisting foreclosure proceedings fell within the reach of those provisions. The borrower was not improperly prevented from filing for bankruptcy, but filing triggered personal liability.

172 Madison (N.Y.) LLC v. NMP-Group, LLC, 650087/2010, 2013 WL 550141 (N.Y. Sup. Ct. Oct. 3, 2013) – Borrower filed a voluntary bankruptcy petition to stop a foreclosure. Filing bankruptcy triggered the guarantors' personal liability even though original foreclosure petition had not sought to hold guarantor's personally liable.

UBS Commercial Mortgage Trust 2007-FLI v. Garrison Special Opportunities Fund L.P., 2011 WL 4552404 (N.Y. Sup. Ct. Mar. 8, 2013) – Court rejected argument the carve-out was against public policy, finding "if there is a need to address the present situation, it is the operation of a legislative or executive function."

J.E. Robert Co. v. Signature Properties, LLC, 2010 WL 796774, at *13 (Conn. Super. Ct. Feb. 3, 2010) – Borrower breached the terms of a mortgage by transferring collateral without the lender's consent when it terminated a parking agreement. The borrower was required to enter into the parking agreement as part of loan transaction and forbidden to transfer any property with out lender's consent. Case involved the viability of the carve-out for "unpermitted transfer of any part of the property without the lender's consent." Mortgagor terminated the parking agreement. The term "transfer" broadly construed to include ancillary agreements such as the parking agreement.

Steven Weinreb v. Fannie Mae, 993 N.E.2d 223 (2013) –Defendant argued he did not read the guaranty because too long and complex, loan documents were ambiguous, carve-outs were unenforceable penalties, and agreement was "unconscionable." Court rejected all arguments and also enforced the prepayment penalty applied when the lender accelerated after default.

Case Summaries Relating to Bad Boy Guaranties
Cases Finding No Liability for Guarantor

ING Real Estate Finance (USA) LLC v. Park Avenue Hotel Acquisition, LLC, 2010 WL 653972 (N.Y. Sup. Ct. Feb. 24, 2010) - Carve-out on a $90 million loan for failure to timely pay property taxes (less than $300,000). Taxes were paid 6 days late. Court found 30-day cure period in credit agreement applied. Court applied liquidated damage analysis: 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.

Case Summaries Relating to Bad Boy Guaranties
Cases Finding No Liability for Guarantor

GECCMC 2005-C1 Plummer Street Office Ltd. Partnership v. NFC NNN Holdings, LLC, 204 Cal. Rptr. 3d 251 (Cal. Ct. App. 2012) - $44 million mortgage secured by two commercial properties subject to two leases to a single tenant. Carve-out if either lease cancelled without prior written consent. Tenant abandoned the property and ceased paying rent. Court ruled carve-out not triggered because the borrower did not terminate leases. Landlord termination did not occur because the landlord never gave notice of termination to the tenant. The tenant's failure to pay rent and abandonment of the property did not terminate the lease

Case Summaries Relating to Bad Boy Guaranties
Cases Finding No Liability for Guarantor

Wells Fargo Bank v. Palm Beach Mall, LLC, 2013 WL 6511651 (Fla. Cir. Ct. 2013), *affirmed*, 177 So.3d 37 (Fla. 4th Dist., Sept. 30, 2015) – Lender argued SPE covenants required borrower to remain solvent, prohibited borrower from accepting capital contributions from the guarantor in order to pay debt service, and gross negligence or willful misconduct by failing to renew leases and implement plan to redevelop the mall. Ct. rejected motion for summary judgment, finding factual disputes and also finding the terms "single" and "separate" in the SPE covenants, do not mean the same thing. Court of Appeals affirmed. The mortgagor is not automatically insolvent whenever its liabilities exceed its assets; covenant requiring borrower to pay is own liabilities and expenses was not violated because funds contributed by guarantor, once contributed, belonged to the borrower; and gross negligence or willful misconduct requires finding a deliberate act by the parties beyond acting out of their own economic self-interest.

Case Summaries Relating to Bad Boy Guaranties
Cases Finding No Liability for Guarantor

CP III Rincon Towers, Inc. v. Richard Cohen, 13 F.Supp.3d 307 (S.D.N.Y., April 7, 2014 – Mechanic's liens, judgment liens and owners' association liens totaled over $250,000. Lender claimed these were impermissible transfers, unpermitted indebtedness and voluntary liens. Definitions of "transfer" and "lien" were internally inconsistent within the loan documents and created ambiguity. Extrinsic evidence showed these were not the types of liens intended to trigger full loan liability. Not "voluntary" because the borrower disputed quality of work and the amount owed. Construction loan contemplated incurring construction costs, and loan documents did not expressly require lender consent to incur those costs.

Malpractice Issues Arising from Bad Boy Guaranties

Lichtenstein v. Willkie Farr & Gallagher, LLP, 120 A.D.3d 1095, 992 N.Y.S.2d 242 (2014 N.Y. Slip Op. 06242) – On the advice of its legal counsel, the borrower on a $4.1 million mortgage loan filed for bankruptcy, exposing the guarantors to $100 million in personal liability. The attorney for the borrower advised the director/guarantor he had a fiduciary duty to file for bankruptcy even though it would trigger personal liability. The guarantors sued the attorney for legal malpractice, arguing the director would have been protected from a breach of fiduciary duty claim because he was exercising his business judgment. They also argued the attorney overlooked the defenses to be raised against the lenders.

The court found no legal malpractice: the business judgment rule only protects disinterested directors, and the lenders committed no wrongdoing in negotiating the guarantees in the course of an arms length transaction.

Specific Arguments and Defenses in Bad Boy Guarantie Cases

Argument No. 1

- Which state's substantive law applies ?
- Usually in a diversity action, the substantive law of the forum state.
- Which state's law governs the interpretation and enforcement of the loan agreement?
- Look to the contract to determine which law to apply
- Courts usually run through its standard for contract interpretation: Construed as a whole, is the contract language ambiguous? Then interpret contract as written. But if ambiguous, permit introduction of parol evidence.

Argument No. 2

- Is it clear on the face of the agreement that if defendant did not comply with a covenant, then plaintiff's agreement not to pursue recourse liability is rendered null and void?

- Defendants contend that the recourse liability must first be established before the guarantor can violate such covenant. *51382 Gratiot Ave., 835 F. Supp. 384.*

- Whose reading of the the contract is consistent with the contract's plain meaning? *Id. at 394*. Plaintiff's interpretation is overly broad. Allowing full recourse liability makes superfluous other springing obligations within the agreement. Plaintiff's interpretation leads to absurd results.

Argument No. 3

- Does public policy void the springing guarantee?

- *51382 Gratiot*: "*When those agreements provide that the occurrence of a springing recourse event makes a borrower or its guarantor personally liable for a commercial mortgage debt that would have otherwise been nonrecourse, the court will hold those parties to their bargain.*" *Id. at 401*.

Argument No. 4

- Carve-outs alleged by lender are actually liquidated damages but are unenforceable as penalties. *Heller Financial*.
- Lenders are usually seeking the amount left on the loan at the time of the breach. “This amount is the actual damages to Heller based on Lee and Van Why’s breach. Since Section 11(b) involves actual damages it cannot be a liquidated damages provision” *Heller Financial*.
- Bad boy guarantee is also enforceable because such clause fixes liability rather than damages. *CSFB 2001-CP-4 Princeton Park.*

Argument No. 5

- Bad boy guarantee is unenforceable because guarantor exercised his statutory right to file bankruptcy.

- " . . . *the carve-out provisions did not waive, or even compromise, the borrower's right to file bankruptcy, but merely imposed a consequence in the event the borrower exercised that right*." *CSFB 2001-CP-4 Princeton Park.*

Argument No. 6

- Curing the breach that triggered personal liability eliminates the springing guarantee. *CSFB 2001-CP-4 Princeton Park*.

- Even though a default is cured, the subsequent cure is ineffective to avoid recourse liability for the partnership and its partners. *Id. at 123-124.*

- For example, payoff of subordinate loan (which was obtained in violation of a covenant) even thought paid off well before the default on the principal loan does not alter the breach of the loan and agreement by the guarantors. *Id. at 124*. Failure to have bankruptcy dismissed within 90 days triggered recourse liability, and, could not be cured by dismissal after the 90 days. *Id. at 124*.

Argument No. 7

- Mortgage containing springing guarantee was extinguished upon foreclosure thereby barring plaintiff's claim because the mortgage was eliminated after the foreclosure sale, at which time the mortgage-no longer existed. *Cherryland*.

- Lower court concluded that the the terms of the mortgage had not been extinguished by foreclosure because the mortgage provided for indemnification for losses based on the failure of the mortgagor to comply survived foreclosure.

- Court of Appeals said it is unnecessary to determine whether mortgage had been extinguished because the basis for deficiency lawsuit is the note. *Id. at 806*.

Argument No. 8

- The springing guarantees violate public policy. *Cherryland*.

- " *. . . making social policy is a job for the Legislature, not the courts*." *Id. at 816.*

- " *. . . the mortgage, as incorporated into the note, unambiguously required Cherryland to remain solvent in order to maintain its SPE status. Having admittedly become insolvent, Cherryland violated the SPE requirements, resulting in the loan becoming fully recourse*." Id. at 816.

Argument No. 9

- The carve-out provision is vague, ambiguous, overly broad and unenforceable penalty provision. *Freed.*

- *"If a court can ascertain its meaning from the plain language of the contract, there is no ambiguity."*

Argument 10

- Lender waived its right to seek recourse against Brookhaven (borrower) and its partners (guarantors) by entering into a Cash Collateral Stipulation. *First Nationwide Bank*.

- The Stipulation in First Nationwide a) did not dismiss or otherwise resolve the bankruptcy proceeding within 90 days as required by the non-recourse agreement; b) did not permit the lender to enforce its security interest; and c) lender was not required to enforce its rights against guarantor during the pendency of the the bankruptcy. *Id. at 621*.