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"Bad Boys, Bad Boys, Whatcha Gonna Do?": Triggering Full Recourse Liability under Non-Recourse Guaranties

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Under the traditional model of real estate financing, lenders typically have two avenues of repayment in the event of a borrower default: exercise of remedies under a deed of trust (or mortgage) encumbering the subject property of the loan and a guaranty given by the principals of the borrower. However, as the commercial mortgage-backed securities ("CMBS") market began its boom over the last two decades, so did the concept of a "non-recourse" loan. In exchange for isolating the borrower and its assets in a special purposes entity ("SPE"), lenders would limit their exercise of remedies against a personal guarantor in certain circumstances. These limitations vary in scope - from liability only for actual loss to full recourse liability - and are triggered by certain "bad boy" acts of the borrower (or such guarantor), typically thought of as intentional, willful misconduct in the form of becoming insolvent, impermissibly transferring or further encumbering the subject property or incurring debt with another lender. As long as everyone played by the rules, the "non-recourse" concept had advantages for both parties; the borrower and its principals would be shielded from potentially expensive personal liability and deficiency judgments, and the lender had a source of repayment for its loan free from other creditors.

Two recent Michigan cases have turned the traditional interpretation of "bad boy" carve-outs to non-recourse guaranties on its ear, however, each by taking a more expansive interpretation of the language of the subject loan documents. In *Wells Fargo Bank, N.A. v. Cherryland Mall*, the court imposed full recourse liability on the guarantor upon the borrower's failure to pay its debts as they became due, which it read as a requirement of SPE status per the language of the mortgage. Similarly, in *51382 Gratiot Avenue Holdings, Inc. v. Chesterfield Development Company*, the court upheld a $12,000,000 deficiency judgment against a guarantor after the borrower defaulted on the underlying mortgage, finding that the borrower's failure to pay the loan as required triggered full recourse liability for violating the covenant to generally pay its debts as they became due. Each of the courts acknowledged that these findings seem to go against the standard marketplace understanding of a non-recourse loan, but, as the court in *Cherryland* opined, "the documents at issue appear to be fairly standardized nationwide and defendants elected to take that risk . . . it is not the job of [the] Court to save litigants from their bad bargains or their failure to read and understand the terms of a contract."

It's too early to tell how great an impact these cases will have on the CMBS market as a whole - both are currently under appeal, and the Michigan state legislature recently enacted a law that prohibits a lender from using a borrower's insolvency to trigger a springing full recourse guaranty - but the potential effects still could be disastrous if they become more widely adopted. With the same real estate players forming a succession of SPEs for individual projects, just one imposition of traditional full recourse liability could take out secondary repayment sources for numerous loans (just think of how many overlapping guarantors you have across various loans in your portfolio right now). So, while you likely don't need to lose too much sleep over these cases tonight, you probably will wonder what you, or your clients, are going to do when and if lenders attempting to enforce a bad boy carve-out to a "non-recourse" guaranty come for you or your clients.

For more information about this topic, please contact the author or any member of the Williams Mullen Financial Services

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