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Enforceability of Nonrecourse Carve-Outs and Springing Guarantees

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The use of nonrecourse carve-out clauses and so-called "springing" or "bad-boy" guarantees in commercial lending is a relatively new concept. Accordingly, case law dealing with their enforceability is not very well developed. The courts that have addressed these issues have uniformly held that such lender safeguards are generally enforceable. This article analyzes these early decisions.

Nonrecourse Carve-outs

In *Heller Fin. Inc. v. Lee*, [1] real estate developers entered into a nonrecourse loan to purchase the Hotel Royal Plaza in Orlando, Fla. [2] The promissory note included a nonrecourse carve-out clause that provided that each maker of the note would be jointly and severally liable for the loan obligations if certain covenants in the loan agreement were breached, including the covenant not to encumber the hotel with any additional liens without the lender's prior written consent. [3] After the loan was funded and the hotel was purchased, six additional liens were asserted against the hotel without the lender's advanced written permission. [4] The lender subsequently issued a notice of default, sold the hotel and filed a lawsuit against the developers personally seeking a deficiency judgment for the remaining indebtedness. [5] The developers argued that the nonrecourse carve-out clause was a liquidated damages provision and constituted an unenforceable penalty against the developers. [6] Explaining the nature of a nonrecourse carve-out, the court recognized that:

> nonrecourse loans create issues in terms of the motivation of borrowers to act in the best interest of the lender and the lender's collateral. As a result, lenders identified defaults that posed special risks and carved them out of the general nonrecourse provision. These carve-outs provide the protection that lenders require, personal liability, to insure [sic] the incentive to repay the loan and maintain the viability of the collateral. [7]

The court then held that the nonrecourse carve-out clause was not a liquidated-damages provision, reasoning that "in interpreting provisions [that] affix the amount of damages in the event of a breach, courts lean toward a construction that excludes the idea of liquidated damages and permits parties to recover only damages actually sustained... Since Section 11(b) involves actual damages [*i.e.*, the deficiency amount], it cannot be a liquidated-damages provision." [8]

Similarly, in *CSFB 2001-CP-4 Princeton Park Corp. Center LLC v. SB Rental I LLC*, [9] the court enforced a nonrecourse carve-out clause where the borrower violated a covenant not to encumber the collateral with any other liens without the advanced written consent of the lender. As in *Heller*, the borrowers argued that the nonrecourse carve-out was an unenforceable liquidated-damages clause. The court rejected that argument, concluding that "[n]onrecourse carve-outs 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." [10] The court further reasoned that

> [t]he carve-out clause is not a liquidated damages provision for yet another reason: [I]t provides for 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... 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. [11]

Accordingly, the court affirmed the deficiency judgment entered against the borrower and guarantors. [12]

In *LaSalle Bank NA v. Mobile Hotel Props. LLC*, [13] the court enforced a nonrecourse carve-out clause in a commercial mortgage when the borrower violated a loan covenant by amending its articles of incorporation so that it was no longer a single-purpose entity. Despite the borrower's argument that the change was "innocuous" and merely added "boilerplate" language to the articles of incorporation, the *LaSalle*

court held that "[t]he language of the mortgage means what it says. [Borrower]'s amendment of its Articles of Organization breached the covenant to maintain its status as a single-purpose entity and triggered the full recourse provision of the mortgage." [14]

In *FDIC v. Prince George Corp.*, [15] the court held that policy considerations did not prevent a lender from collecting a deficiency judgment against the borrower's partner (PGC) under a nonrecourse carve-out provision in the underlying loan documents. In *Prince George*, liability for the deficiency amount was triggered by the filing of an involuntary petition for bankruptcy by PGC against the borrower. [16] On appeal, PGC argued that it had a statutory right to file an involuntary bankruptcy petition against the borrower and any waiver of that right under the nonrecourse carve-out clause is void as against public policy. [17] The court disagreed, reasoning that "[t]his argument ignores the fact that the note did not prohibit PGC from resorting to bankruptcy; it merely provided that if PGC took certain actions, it would forfeit its exemption from liability for any deficiency." [18] Accordingly, the court affirmed the lender's deficiency judgment against PGC. [19]

Springing Guarantees

Courts have likewise enforced springing guarantees executed in connection with a commercial non-recourse loan. In *Blue Hills Office Park LLC v. JPMorgan Chase Bank*, [20] the court enforced a springing guaranty for personal liability against two real estate developers that failed to disclose or pay over to the lender a $2 million settlement related to a commercial development dispute. The loan at issue was a typical commercial mortgage-backed security (CMBS) nonrecourse loan to a single-purpose entity (SPE). [21] The lender required that the individual developers behind the SPE execute a springing guaranty in connection with the loan that would trigger full liability for the indebtedness against the individual developers upon the occurrence of certain events, including the transfer of mortgaged property without the advance written consent of the lender. [22] After the loan was made, the SPE became involved in a zoning dispute with a neighboring property, which ultimately settled for $2 million. [23] The developers did not notify the lender of the settlement and transferred the $2 million into their personal accounts. [24] The SPE subsequently defaulted on the loan, and the property was sold at a foreclosure sale. [25] Upon learning of the $2 million settlement, the lender sued the individual developers for the full amount of the outstanding deficiency under the loan. [26] The court held that the springing guaranty was enforceable and entered judgment against the individual developers for the entire deficiency amount due, including all accrued interest and more than $2 million in attorneys' fees and costs, which judgment exceeded $17 million. [27]

In *111 Debt Acquisition LLC v. Six Ventures Ltd.*, [28] the court enforced a springing guaranty against individual guarantors when the borrower filed for bankruptcy. After the borrower defaulted under the loan, the lender sought the emergency appointment of a receiver. [29] On the day of the receiver hearing, the borrower filed for bankruptcy. [30] The lenders then filed a complaint against the guarantors for the full amount of the outstanding indebtedness, equal to $20.9 million. [31] The individual guarantors argued that allowing the lender to recover damages for the borrower's bankruptcy filing "violates public policy in that it restricts duties owed by [borrower] to other creditors when [the borrower] became insolvent." [32] The court rejected the guarantors' argument, explaining:

> First, obtaining a judgment against the guarantors of a corporation's debt is not void as contrary to public policy. Rather, the inverse is true. Individuals are permitted to contractually obligate themselves to pay the debts of another and, if those debts are not paid, obtaining a judgment is the only manner by which a plaintiff can obtain a judicial declaration that the guarantors are indebted to the lender.
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> * * *
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> Further, [the] Guarantors' argument that the bankruptcy filing/Springing Recourse Event clause places them in an "untenable situation" lacks merit. This Springing Recourse Event created liability for the individual guarantors—it did not prevent [the borrower] from seeking protection afforded by the Bankruptcy Code. [33]
>
> Accordingly, the court entered summary judgment in favor of the lender and against the individual guarantors.

Bankruptcy Considerations

Some borrowers and guarantors have challenged nonrecourse carve-outs and springing guarantees that are triggered when a borrower files for bankruptcy protection as an unenforceable *ipso facto* clause prohibited by § 365(e)(1) of the Bankruptcy Code, which provides:

> Notwithstanding a provision in an executory contract or unexpired lease, or in applicable law, an executory contract or unexpired lease of the debtor may not be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on—
>
> > (A) the insolvency or financial condition of the debtor at any time before the closing of the case;
> >
> > (B) the commencement of a case under this title; or

> (C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement. [34]

Most courts have rejected this argument, recognizing that § 365(e)(1) only applies to "executory contracts," meaning contracts where obligations remain on both sides, and only to executory contracts "of the debtor," not an agreement or obligation of some other third party, such as a related borrower or guarantor.

In *First Nationwide Bank v. Brookhaven Realty Assocs.*, [35] the court affirmed a deficiency judgment against the borrower and its individual partners as a result of the borrower's bankruptcy filing. The loan agreement at issue in *Brookhaven Realty* was nonrecourse but contained a carve-out in the event that the borrower filed for bankruptcy and the case was not dismissed or otherwise resolved within 90 days. [36] After the lender filed to foreclose on the collateral, the borrower filed for bankruptcy. [37] The borrower's bankruptcy case was ultimately dismissed, but long after the 90-day grace period provided under the carve-out. [38] Following the dismissal, the lender sought a deficiency judgment against the borrower and the individual partners. [39] The borrower argued that allowing a deficiency judgment that was triggered solely by its bankruptcy filing would violate § 365(e). [40] The court rejected the borrower's argument, finding that, as an initial matter, § 365(e) did not apply because the mortgage was not an "executory contract" as that phrase is interpreted under the Code. [41] The court continued:

> Moreover, the policies of providing a debtor with a fresh start and an opportunity to organize its finances are not present in a foreclosure proceeding. Nor does the Bankruptcy Code's broad purpose of protecting the debtor's estate to permit the equitable distribution of assets to the creditors apply here. [42]

Accordingly, the court affirmed the trial court's deficiency judgment against the borrower and the individual partners.

More recently, in *Monroe Center II Urban Renewal Co. LLC v. Strategic Performance Fund-II*, [43] the court affirmed a trial court judgment against two individual guarantors under a carve-out guaranty agreement executed with an affiliate of the borrower in connection with a $41 million construction loan. On appeal, the guarantors argued that § 365(e)(1) precluded the lender's ability to pursue the guarantors on account of the borrower's bankruptcy filing. [44] The court disagreed and affirmed the judgment, stating:

> We agree with the trial court's conclusion that the protections afforded to debtors under § 365(e) do not extend to [affiliate of borrower]. However,

> we reach this conclusion not solely because of [affiliate of borrower]'s status as a non-debtor as the trial court found. Rather, also significant is the fact that the Carveout Agreement represents "an independent obligation" of [guarantors], which "happens to have been triggered" by [borrower]'s default and resort to bankruptcy. [45]

In support of this ruling, the *Monroe Center* court relied on the prior decision of the First Circuit Court of Appeals in *Liberty Mut. Ins. Co. v. Greenwich Ins. Co*., [46] which affirmed a judgment against a surety that was triggered on account of the insured's bankruptcy filing. Like the guarantors in *Monroe Center*, the surety claimed that § 365(e)(1) prevented a liability from contractually springing into existence due to the insured's bankruptcy filing. [47] Analyzing § 365(e)(1), the court explained that "a careful reading of the statute and an understanding of its purpose readily confirm that—whatever protection the statute may give [the debtor] in protecting its own rights *vis-à-vis* [plaintiff] under the agreement—the statute in no way invalidates a separate claim by [plaintiff] against [surety] under the bond." [48] The court thus concluded that "[t]he bond is an independent obligation of [surety] which happens to have been triggered by a third party's nonpayments of debts and resort to bankruptcy." [49]

As the foregoing cases illustrate, although the use of nonrecourse carve-outs and springing guaranties is of relatively recent vintage, lenders should feel comfortable that these protections will be enforced in court.

1. 2002 WL 1888591 (N.D. Ill. Aug. 16, 2002).

2. *Id*. at *1.

3. *Id*.

4. *Id*. at *2.

5. *Id*.

6. *Id*. at *4.

7. *Id*. (internal citation and quotations omitted).

8. *Id*. at *5.

9. 980 A.2d 1 (N.J. Super. Ct. App. Div. 2009).

10. *Id*. at 5.

11. *Id*.

12. *Id*. at 7.

13. 367 F.Supp.2d 1022 (E.D. La. 2004).

14. *Id*. at 1030.

15. 58 F.3d 1041 (4th Cir. 1995).

16. *Id*. at 1045.

17. *Id*. at 1046.

18. *Id*.

19. *Id*. at 1047.

20. 477 F.Supp.2d 366 (D. Mass. 2007).

21. *Id*. at 369-70.

22. *Id*. at 370, 381.

23. *Id*. at 370.

24. *Id*.

25. *Id*. at 371.

26. *Id*.

27. *Id*. at 381-82, 391-92.

28. 2009 WL 414181 (S.D. Ohio Feb. 18, 2009).

29. *Id*. at *1.

30. *Id*.

31. *Id*. at *2.

32. *Id*. at *11.

33. *Id*.

34. 11 U.S.C. § 365(e)(1).

35. 223 A.D.2d 618 (N.Y. App. Div. 1996).

36. *Id*. at 619.

37. *Id*.

38. *Id*.

39. *Id*. at 620.

40. *Id*.

41. *Id*.

42. *Id*.

43. 2010 WL 5343317 (N.J. Super. Ct. App. Div. Dec. 29, 2010).

44. *Id*. at *2.

45. *Id*. at *3.

46. 417 F.3d 193 (1st Cir. 2005).

47. *Id*. at 198.

48. *Id*.

49. *Id*. at 199.