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Loan Carve-Outs For Nonrecourse Financing

Including certain provisions will allow a lender to recover deficiencies or damages resulting from unanticipated borrower events.

By Karl E. Geier

In a nonrecourse loan, a lender fundamentally agrees to limit its recourse to specified assets rather than to the general assets of the borrower or the guarantors. Nonrecourse carve-outs are contractually created exceptions to the general nonrecourse nature of the financing. They allow the lender to pursue claims against a borrower's or guarantor's general assets rather than strictly the collateral for the loan.

These carve-outs need to be structured into the contractual terms of the loan documents or the guaranty, and will vary somewhat depending on the structure of the transaction and the bargaining leverage of the parties.

The purposes of nonrecourse financing usually relate to the rules for allocation of partnership tax basis to limited partners under Internal Revenue Code Section 472. These rules, in essence, deny limited partners the right to include nonrecourse financing in their tax basis unless the debt is without recourse to all the parties, including the general partners. The same principles apply in a limited liability company (LLC).

A fully recourse loan or guaranty, in either event, can have the result of precluding all non-guaranteeing partners or members the right to include any of the debt on their basis for tax purposes.

In some transactions, nonrecourse financing is not so much driven by tax considerations as by asset preservation strategies of the principals of the borrowers, who prefer to segregate assets in separate entities and avoid personal liability for the indebtedness of those entities. In this context, the availability of nonrecourse financing and the scope of any nonrecourse carve-outs is a matter of market conditions and negotiating leverage.


Karl E. Geier

Due to the practical nonrecourse character of debt issued by LLCs with no assets other than the project collateral, the extent of carved-out recourse liability most typically arises in a guaranty. But the same general issues can exist for an operating company with multiple projects that desires to limit or segregate recourse to particular projects or, in a partnership context, in defining general partner liability for an otherwise nonrecourse loan.

Legitimate expectations

In any of these contexts, the fundamental business agreement between the lender and the other loan parties is that the borrower or guarantor has no liability, except to the extent of the pledged collateral, and that the lender has no recourse, other than to the pledged collateral. The negotiation of carve-outs or exceptions to this can be problematic because they cut against the grain of the fundamental bargain between the parties.

The primary purpose of the carve-outs is to prevent dissipation of the lender's collateral through fraud, theft, waste, rent skimming or other events where it would be inequitable for the borrower or guarantor to benefit at the lender's expense.

From the borrowing group's standpoint, the lender should not be using carve-outs to convert the nonrecourse loan facility into the practical equivalent of a fully recourse loan. This stipulation is particularly important when the risk to investors includes inability to treat the loan as nonrecourse debt within the meaning of Treasury Regulation 1.752-27 and Internal Revenue Code Section 465(b)(6).

The carve-outs must be narrowly drafted to protect only against the risk of dissipation or loss of collateral and against fraud by the borrowing group. Otherwise, they may be considered to create a recourse obligation that precludes limited partner or member inclusion of the debt in the tax basis of limited partners or LLC members.

The lender has a legitimate interest in realizing the full value of its collateral, which is essentially all the borrowing group has offered to induce the lender to make the loan. The lender should view the carve-outs as a mechanism for preserving access to the collateral or assuring that the value of the collateral can be retrieved if the borrower group should lose, waste, squander, steal or hide a portion of the property pledged to the lender.

The borrower group should not be resisting the legitimate protection of lender's interest in the value of and ability to realize on the collateral, including the lender's right to the income and other proceeds of the collateral, nor should the borrower group be resisting liability for fraudulently inducing the lender to make the loan.

Terminating recourse protection

The mechanics of nonrecourse carve-outs depend somewhat on the structure of the loan and of the borrowing entity. In most cases, the loan remains nonrecourse as to the borrowing entity (which generally has no appreciable separate assets anyway), but the lender obtains the right to pursue claims against the guarantor or general partner for specified damages or other limited recourse items.

In some situations, carve-outs merely permit recovery of specific amounts or items of property wrongfully taken or divested from the collateral pool (a type of "claw-back" provision).

Sometimes, lenders provide that the entire loan become fully recourse to the borrower or the guarantors in the case of certain events, usually associated with bad faith, bankruptcy or other serious breaches of the fundamental basis upon which the initial nonrecourse bargain was struck. (These provisions are typically known as "barracuda" provisions or "bad boy" provisions.)

Provisions that allow the lender to recover deficiencies or damages resulting from the following carve-outs are common and generally noncontroversial, although the exact terms may be vigorously negotiated. These provisions may include the following:

- undisclosed or newly discovered environmental contamination and related claims;
- borrower-caused damage or physical waste - particularly if intentional or in bad faith;
- rent-skimming - e.g., borrower retention of rents while unpaid property expenses, taxes or liabilities remain (especially shortly before or after default);
- diversion of condemnation or insurance proceeds other than to restoration of the property or paydown of the loan;
- payment of insurance deductibles or loss retention amounts;
- uninsured or underinsured loss permitted by loan documents (although lenders often will be expected to bear the loss for risks that cannot be insured at commercially reasonable rates, such as earthquake damage);
- loss resulting from failure to maintain insurance as required by the loan documents;
- failure to deliver security deposits, advance rents and other tenant funds to the lender upon foreclosure;
- damages attributable to fraud or misrepresentation at inception of loan; and
- removal or disposition of portions of the collateral (e.g., furniture, fixtures and equipment) following default.

Controversial carve-outs

The following types of carve-outs may be criticized as over-broad or unduly undermining the basic business assumption that the lender's primary recourse is to the collateral:

- the lender for property damage or deterioration of collateral caused by the borrower's mere negligence;
- general indemnity provisions (other than for a borrower's willful or intentional misconduct or violation of law);
- debt collection costs incurred by the lender following default (other than to enforce nonrecourse carve-outs);
- decline in value of collateral due to market conditions or general wear and tear;
- breach of anti-bankruptcy covenants, other than voluntary bankruptcy;
- breach of proscriptions on transfer or subordinate liens without lender consent (unless due to voluntary acts of the recourse party); and
- prepayment fees, defeasance costs and other penalties due to involuntary events leading to early paydown of the loan.

Conversely, here are some generally legitimate "bad boy" clauses. These types of borrower conduct may justify removal of some or all of the nonrecourse protections of the loan as to the borrower and/or the guarantor

These actions include volitional breach of a due-on-sale or due-on-encumbrance clause; voluntary breach of the lock-in character of the loan (or failure to pay a prepayment premium penalty for a volitional act resulting in prepayment); voluntary filing of a bankruptcy or reorganization proceeding; frivolous or bad-faith claims of lender liability; frivolous or bad-faith delaying tactics and opposition to foreclosure; and fraud involving material misrepresentations regarding the borrower, the loan, the rental income from the property or the condition of the property.

Although courts have upheld these provisions in some situations, the following actions are questionable and may be viewed as overreaching by the lender from a business standpoint: validly contesting the lender's foreclosure action based on legitimate grounds, such as a wrongful failure to disburse or incorrect claim of default; or environmental contamination of the property that is known to the lender or that occurs after the loan is made through no fault of the borrower.

Although only a few reported decisions have considered the enforceability against guarantors or borrowers of nonrecourse provisions and carve-outs, the limited case authority that does exist upholds such provisions.

For example, in Blue Hills Office Park LLC v. JP Morgan Chase Bank, the Federal District Court in Massachusetts upheld a draconian "bad boy" provision that made the guarantors liable for the entire loan deficiency in case of breach of certain specialspurpose entity provisions and improper transfers of funds out of the borrowing entity.

The guarantors argued that their only liability should be for the actual damage to the lender resulting from these improper acts, but the court upheld the literal terms of the carve-out provision, which made the guarantors liable for the entire amount of the loan less the remaining value of the collateral.

In another case, Diamond Point Plaza Limited Partnership v. Wells Fargo Bank NA, the Maryland State Court of Appeals upheld a judgment for the full amount of the loan based on a provision that canceled the nonrecourse nature of the loan for borrower fraud.

In this case, the borrower had concealed or actively misrepresented a major tenant's plans to vacate the shopping center that was the collateral for the loan. The court upheld the provision, even though the tenant continued to pay the rent.

In a similar case, Heller Financial v. Lee, the court upheld a provision converting the loan to full recourse following breach of the borrower's covenant against encumbrances.

Enforceability

Each of these cases reflect the strong inclination on the part of the courts, particularly where the parties are sophisticated and represented by counsel, to enforce the unambiguous terms of a contract, regardless of how unfair or overbearing they may appear to be. As a result, borrowers, guarantors and their counsel will attempt to limit the scope of the nonrecourse carve-out provisions at the time of loan negotiation, and will resist broad brush "bad boy" provisions that convert the loan entirely into a recourse facility either to the borrower or the guarantors.

These negotiating positions should not be viewed as inappropriate by lenders, unless the borrower group is seeking to avoid responsibility for the most extreme sorts of defalcations and other misconduct.

It is possible that a nonrecourse carve-out, particularly a "bad boy" clause that triggers the full collectability of the loan if the borrower or guarantor seeks protection under the U.S. Bankruptcy Code, may be challenged as an improper ipso facto clause in a bankruptcy context.

A handful of cases have ruled on the validity and enforceability of such provisions, including First Nationwide Bank v. Brookhaven Realty Association and Federal Deposit Insurance Corporation v. Prince George Corp. Both of these cases upheld conversion of loan to full recourse upon the filing of a voluntary bankruptcy.

The courts determined that the Bankruptcy Code did not apply, because it only applies to executory contracts - not mortgages - and once the bankruptcy case was dismissed, the enforceability of the carve-out was a matter of state law rather than bankruptcy law. **CMI**

Karl E. Geier is a shareholder at Miller Starr Regalia's Walnut Creek, Calif., office. He can be reached at (925) 935-9400 or keg@msrlegal.com.