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Non-Recourse Carveouts (and We Really Mean It)

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In a case of first impression in New Jersey, the Superior Court of New Jersey recently held that the obligor under a guaranty of non-recourse carveout obligations would be strictly held to its promise to repay an entire loan, even when the event that triggered the non-recourse obligation arguably caused no damages to the party seeking enforcement.

The case, *CSFB 2001-CP-4 Princeton Park Corporate Center LLC v. SB Rental I LLC* , decided in August, puts a punctuation mark of certainty on the interpretation of such agreements, and is in accord with a number of other cases decided in various jurisdictions around the country. Not surprisingly, non-recourse guaranties are the focus of a lot of attention these days as more and more projects enter workout and beyond.

Back in the day — and this was not so long ago — lenders aggressively sought the opportunity to finance attractive real estate projects on a one-off basis. Relying on healthy valuations (which were always projected to go up) and cash flow projections (ditto, once the requisite number of quality tenants were signed up), development projects were evaluated on their own merits as stand-alone propositions, and that was the way the both borrowers and lenders wanted it. "Special-purpose" or "single-purpose" entities were often required, which, while they might not meet the requirements of a securitization, were considered adequately insulated to allow the lender to view the project on its own merits, without being exposed to the unknown risks of the developer's other projects. And borrowers, though always optimistic, derived comfort from the limitations on liability, as well as from simplified loan relationships and underwriting requirements.

In understanding non-recourse loans, it is useful to consider their development as evolutionary. In a simple case, a borrower might own many properties and therefore, while separate lenders might take mortgages on individual properties, the financial strength of the borrower could be driven by a wide variety of factors and the results of many projects. A simple "non-recourse" structure could be created simply by placing the property in a single purpose entity. In such cases, even though there was no contractual limitation on liability at the borrower level, the simple lack of any borrower assets — other than the property being financed — meant that the

loan was effectively non-recourse, at least as far as the developer was concerned. And the lender could focus on the deal at hand.

As the advantages of such structures became apparent and competition in real estate lending intensified, the borrower's non-recourse treatment was formalized by the adoption of language that explicitly restricted the lender's recourse to the real property being financed.

"Carveouts" to the non-recourse structure evolved as lenders recognized that there could occur certain intentional or bad acts on the part of the borrower or its owners that might lead to losses at the project, and for which the lender had no intention of letting borrowers escape liability. Thus, if the owners walked off with the rents, or failed to pay taxes, for example, language evolved that would reinstate the personal liability of the borrower. Moreover, the concept of non-recourse guaranties was developed to put the owners personally on the hook for such losses, even when a special purpose entity was used.

These provisions were then refined in two significant ways. First, the list of carveout items grew to cover a multitude of sins, and even some non-sin risks that the lenders decided they were not in the business of assuming. Thus, environmental problems became a carveout item. Over time, even the voluntary bankruptcy of the borrower began to appear as a non-recourse carveout, notwithstanding the fact that such a filing might be the most efficient way to deal with a failed project.

The second, more subtle development occurred in the language defining the extent of the carveout. Originally, many provisions simply stated that the guarantor would fully guaranty the loan if a violation of the carveouts occurred. Over time, this came to be modified in some cases to state that the guarantor would be liable "only to the extent of actual damages, including enforcement costs, incurred as a direct result" of the specific violation. Given the general sense that the carveouts were intended to provide redress for specific issues, this was usually acceptable to the lenders. Even so, in many cases, as in *CSFB* , the old, broader form of carveout provision continued to be used.

In general, the *CSFB* case stands for the not-so-shocking proposition that sophisticated parties that negotiate non-recourse provision will be held to their agreements. More specifically, it provides a cautionary tale for borrowers who might be tempted to risk violating a restriction that on its terms triggers full recourse, in the belief that a court of equity will only hold them to be liable to the extent that their violation directly damages the lender.

On May 2, 2001, the defendant in this case, SB Rental, borrowed $13.3 million from the plaintiff's predecessor-in-interest, as noted in the opinion. The loan was secured by a mortgage on a property in South Brunswick, N.J. The loan was structured as a non-recourse loan, meaning that the lender would be limited to exercising its rights against the property in the event of a default.

However, the note provided that the borrower would be personally liable for the entire amount of the loan in the event that certain carveouts were violated. These restrictions included a prohibition on the borrower placing subordinated debt on the property without the lender's consent. The principals of SB Rental personally guaranteed the loan, subject, however, to the

same non-recourse provisions and carveouts; as a result, provided that there was no violation of the carveouts, the principals had no personal liability for the loan.

While the loan was outstanding, the borrower took out a $400,000 loan secured by a subordinated mortgage on the property. This was subsequently repaid without incident and apparently had no negative impact on the borrower's finances. A year and a half later, following loss of its sole tenant, the borrower defaulted on the loan. The lender foreclosed on the property, but this did not pay off the loan.

Subsequently, the lender instituted an action against the borrower and the principals for the deficiency, based upon the borrower's violation of the restriction against subordinated financing. The defendants argued that the lender had not been harmed by the violation and that, as a result, the carveout clause represented an unenforceable penalty.

The lower court ruled against the borrower and guarantors, characterizing the provision in question as one that was simply a trigger for liability, rather than a proxy for damages. The court ruled that the parties knew the consequences of their actions, and that those consequences were that they would lose their immunity against personal liability, if they engaged in certain conduct. As a result, the loan provisions would be strictly enforced.

The Superior Court agreed with this analysis, noting that the borrower and guarantors had bargained for non-recourse treatment, to the detriment of the lender, but that such treatment was conditional, based upon the borrower's compliance with certain requirements. As in the lower court decision, the Superior Court held that where sophisticated parties with equal bargaining power reach an unambiguous agreement, it should be enforced.

The court rejected the defendants' argument that carveout provisions should be viewed as liquidated damage clauses, reasoning that "they operate principally to define the terms and conditions of personal liability, and not to affix probable damages." "In other words," the court held, "whereas the non-recourse nature of the loan operates as an exemption, the carveouts exist to implicate personal liability." The court noted the basis for the carveouts as a protection for the lender and a factor in the lender's determination of the risk associated with a loan.

The court further made the interesting argument that the carveout was not a liquidated damage provision because it did not create a substitute for, but rather required payment of, "actual damages." In the court's analysis, the damages to the lender were equal to the loss on the loan, in effect skipping over the narrower question of the "actual damages" caused by the specific act that constituted the violation (which is how practitioners usually think of non-recourse violation damages). This reasoning essentially viewed the damaging act as more a case of "wrongfully inducing the lender to make a non-recourse loan," rather than the narrow act of violating the specific carveout. In such a case, it does not matter whether the violation caused the loss or not, as the lender presumably would not have made the loan (at least on a non-recourse basis) if the borrower had confessed its intention to violate the restriction on junior liens.

As noted by the court, a number of other decisions across the country have followed this reasoning. In *First Nationwide Bank v. Brookhaven Realty Associates* , the New York Appellate Division ruled where general partners of a borrower had agreed to personal liability in the event that a bankruptcy occurred and was not dismissed within 90 days, such a provision was

enforceable even though, as a secured creditor, the lender in that case arguably did not suffer material damages by reason of the bankruptcy.

Perhaps more pointed is the case of *Blue Hills Office Park LLC v. J.P. Morgan Chase Bank* , which was also cited by the court. In *Blue Hills* , the non-recourse carveout provision contained in a note and guaranty imposed full personal liability in the event that the property was transferred without the lender's consent. When the borrower settled a zoning appeal in exchange for $2 million (and pocketed these proceeds), the lender successfully argued that the borrower had wrongfully transferred a component of the property (think bundle of sticks), and that the borrower should have full liability. The $17.5 million loan balance well exceeded the $2 million diversion, but was enforced by the court as provided under the loan documents.

Where the parties have reached a specific agreement on what liability will be imposed in the event of a violation of non-recourse carveouts, it is reasonable that this be enforced. In the analysis of the court, SB Rental's complete loss of non-recourse treatment was the bargained-for result, triggered by the voluntary actions of the borrower.

Further, even though the court held that the terms were not damages provisions, as practitioners, we cannot help but also find compelling the deterrent effect that such a provision has, and it clearly is intended to have. To the extent that SB Rental thought it could satisfy any recourse obligations by simply repaying the subordinated debt, in effect "putting back the money," such a provision would have no deterrent effect at all. And where the lender's goal is, as here, to avoid having the borrower act in certain ways to the detriment of the loan, deterrent effect is nearly as important as the question of damages once the restriction is violated.

These facts suggest that it is reasonable for borrowers to expect to be held to the express terms of their loan documents with regard to non-recourse carveouts. They also suggest that when borrowers do negotiate non-recourse provisions (a rarer event these days), they should expect such provisions to be onerous with regard to voluntary acts, while there may be some latitude to negotiate "actual damages incurred" recourse (i.e., short of the full loan amount) with respect to events where the violation is an act or event that is out of the control of the borrower.

As suggested above, inclusion of the voluntary bankruptcy of the borrower as a carveout is a complicated question, given the nature of the violation. However, in today's environment, it is safe to say that the lenders will be calling the shots on this, and all material recourse issues, for some time.

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