

Non-Recourse Mortgage Loans May Not Be Non-Recourse

By Alan Mark

Commercial mortgage-backed securities (CMBS) or Conduit loan borrowers would likely be startled to learn that their so-called **“non-recourse loans” may not be non-recourse after all** when there is a payment default. Contrary to what Conduit borrowers would reasonably believe they had bargained for, a simple payment default (not caused by any fraud, misapplication of funds or other “bad boy” acts) could result in full borrower responsibility for repayment of any deficiency. That is what was argued by Wells Fargo Bank in a noteworthy 2011 Michigan case, (*Wells Fargo Bank, NA v. Cherryland Mall Ltd. Partnership*, 295 Mich.App. 99) - and the Court agreed.

CMBS lenders typically impose requirements on their borrowers designed to minimize the risks of a borrower bankruptcy. Among those requirements are the single purpose entity/separateness covenants (“SPE Covenants”) and it is here where the problem lurks and may linger for years for the unsuspecting borrower and its principals.

In the Michigan case, the SPE Covenants required, among other things, that the borrower pay its debts as they became due. The loan and guaranty documents each contained a proviso that if any SPE Covenant was violated, the borrower and guarantors would lose their contractual non-recourse protections. Both provisions appear almost universally in Conduit loan documents.

The Michigan borrower failed to make a required mortgage installment, precipitating a loan default, whereupon the lender (through Wells Fargo Bank, the special servicer employed to enforce the loan documents upon a default), argued successfully that the mortgage loan payment default was a breach of the SPE Covenants (failure to pay debts as they become due), which stripped both the borrower and loan guarantors of their non-recourse protection. Thus, rather than having insulated themselves from a deficiency claim, the payment default was held to be a full-recourse trigger event. As Joseph Heller might suggest, a classic “Catch-22”: you are not liable for repayment unless you do not pay.

In response to the Court’s decision, the Michigan legislature promptly sought to rectify the situation and passed legislation rendering the Court’s determination of no effect, at least in Michigan.

While the subsequent efforts of Michigan’s legislature do afford non-recourse borrowers the protections they reasonably believed they bargained for with respect to Michigan properties/loans, the situation remains unclear throughout the rest of the Country. No subsequent cases have been reported and little more has been written on the subject over the past 18 months.

Yet given the fact that many, if not most, CMBS loans contain similar SPE covenants and provide for loss of non-recourse status upon an SPE Covenant breach, borrowers and guarantors remain theoretically exposed to full recourse liability on their supposedly non-recourse loans for “simple” payment defaults should the lender pursue the same arguments that were successfully litigated in the Michigan Court of Appeals. The potential springing recourse liability for payment defaults, when coupled with fairly long statute of limitations periods (as long as six years from default/acceleration), leave borrowers and guarantors exposed to significant theoretical – and perhaps not so contingent – liability. How, must or should this potential liability be disclosed on an entrepreneur’s subsequent financial statements? Indeed, a potential borrower could face significant legal exposure for a future failure to disclose such liability (see e.g. 18 U.S.C. §1014).

Given this quandary, can a borrower/guarantor obtain some form of estoppel or waiver from the Conduit lender or its special servicer? It's not likely in the absence of any statutory or common law duty on the lender. Absent payment in full or a legal duty (which does not presently exist), lenders and especially their special servicers are reluctant, and will likely remain reluctant, to provide their customers with such comfort.

The takeaway is that greater attention should be paid to the non-recourse termination provisions when entering into new Conduit loans and a defaulting borrower group should at least raise their concerns about "closing the book" on deficiency liability with their lender in the context of a "friendly" foreclosure.