RECOURSE CARVE-OUT LIABILITY: ONLY FOR BAD BOYS?

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This presentation repeats with some updating a previous presentation to the Mortgage Lending Institute [2], with the subject continuing to be topical in light of recent court decisions in the area of non-recourse carve-out liability and especially what is commonly referred to as "springing liability" or "springing full liability."

1. NON-RECOURSE LOAN CONCEPTS

1.1. Non-Recourse.

One of the common dictionary definitions of the word "recourse" is as follows: "*in business or law*, the right to demand payment from the maker or endorser of an instrument (such as a promissory note or a check)." Non-recourse, then, is the feature of some loans whereby the lender ***does not*** have "the right to demand payment from the maker or endorser." Instead, the lender receives from the borrower a pledge of collateral for the borrower's repayment of the loan; and if the borrower fails to repay the loan, the lender's recovery is limited to its obtaining the collateral, generally by foreclosure. In the event of the borrower's default on a non-recourse loan, if the value of the collateral turns out to be insufficient to satisfy the full amount of the loan balance, then the lender suffers a loss equal to the difference between the loan balance and the value of the collateral.

1.2. Carve-Outs.

A good definition of carve-outs was included in a recent article by John C. Murray, Vice President and Special Counsel for First American Title Insurance Company in the company's Chicago National Commercial Services office in his web article entitled "Enforceability of Carveouts to Nonrecourse Loans: An Update," which can be accessed through the following web link:

http://www.firstam.com/title/resources/reference-information/jack-murray-law-library/enforceability-of-carveouts-to-nonrecourse-loans-an-update.html :

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1 Especially in light of the admittedly editorial tone of some of the comments in this outline, I want to start the outline with the following disclosure, disavowal and apology: (1) Disclosure: The orientation of my law practice for the past twenty years has been predominantly the representation of real estate developers and investors, i.e., not mortgage lenders. (2) Disavowal: I acknowledge that the comments in this outline are solely my own personal observations and conclusions, and they in no way represent the views of Glast, Phillips & Murray or any clients of our law firm. (3) Apology: While I believe the analysis and commentary in this outline to be correct, I apologize in advance to anyone whose opinions may be different and who may be offended by the content or tone of my comments.

2 Wallenstein, *Negotiating Non-Recourse Carve-Outs in Light of Recent Court Decisions*, University of Texas Law School 2012 William W. Gibson, Jr. Mortgage Lending Institute. See also Wallenstein, *An Updated Report and Analysis on Springing Recourse Guaranties in Mortgage Loan Transactions*, June 2011 issue of *eReport* published by the American Bar Association's Real Property, Trust and Estate Law Section. The latter article is attached as an Appendix to this outline.

> "Since the mid-1980s, lenders have been qualifying and restricting nonrecourse provisions in commercial real-estate loans by making exceptions for certain 'bad acts' by borrowers. In recent years, many lenders have expanded the scope of such 'carveouts' to include risks of exposure to the property's economic deterioration or neglect. Some nonrecourse provisions provide that the borrower is liable for the specific damages resulting from the violation or breach of a carveout, while others state that the entire loan becomes recourse to the borrower if any of (or certain of) the excepted acts occurs. In some cases the exceptions have virtually swallowed the rule; i.e., the clause is drafted so that the borrower has personal liability for virtually all defaults except the failure to pay the principal and interest due on the loan."

NOTE: The final sentence in Mr. Murray's article indicates that although dated in calendar year 2011, the article was prepared prior to the December 2011 opinions in Cherryland Mall and in 51382 Gratiot Avenue, as is discussed in Section 2.2.2.B. below beginning at the bottom of the next page.

2. LIABILITY LIMITATION PROVISIONS FROM THE PERSPECTIVE OF THE LENDER AND THE BORROWER

2.1. A Lender's View of Non-Recourse: License for the Borrower to "Take the Money and Run".

Although my law practice has been predominantly oriented towards developer and investor representation for the past 20 years, before that I had a considerable lender orientation to my practice. And I remember the days before non-recourse carve-outs became prevalent, when loan documents often contained absolute non-recourse provisions without any carve-outs. During that period lenders often found that borrowers with no liability under the loan documents, i.e., nothing to lose, failed to maintain properties that they anticipated losing to foreclosure, so that properties on which lenders had just foreclosed were found to suffer from what might charitably be called "deferred maintenance." In one instance during that period prior to the incorporation of non-recourse carve-outs in loan documents, I remember representing a lender who foreclosed on property only to find that a portion of the property had been condemned and the borrower had taken the condemnation proceeds in violation of the mortgage. And in another instance during that period I remember representing a lender who foreclosed on an apartment project on the first Tuesday of a month (which coincidentally was the first calendar day of the month) and who then discovered that the prior month the borrower had distributed a circular to all tenants, offering a 10% discount in the rent for the following month if the tenant paid before the end of the current month.

2.2. A Borrower's View of Recourse Carve-Outs

In my outline for a 2009 presentation to the Mortgage Lending Institute (MLI), I acknowledged that some of my suggestions in that outline might appear to be "nitpick" issues. And in my experience occasionally a lender representative or a mortgage broker has in fact demonstrated impatience with borrower requests for liability clarification, assuring the borrower that the lender will not seek to undercut the non-recourse essence of the loan by asserting interpretations of the loan documents that, while possibly technically defensible, are contrary to that non-recourse essence.

2.2.1. Prior to 2011: the Fictional "Saddlebags" Story.

Even before the 2011 court decisions that I will summarize in Section 2.2.2 below, I had suggested that the borrower's attorney might give thought to the possibility that at some time in the future the borrower will not be interfacing with the same pleasant loan officer who represented the lender at the commencement of the loan transaction but instead will be facing a lender representative comparable

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