RECOURSE CARVE-OUT LIABILITY:
ONLY FOR BAD BOYS?

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1. INTRODUCTION

1.1. Continuity. I have been writing and speaking on the topic of Non-Recourse Carve-outs for at least 17 years[1]. During that time there have been some variations in the quantity and the type of carve-outs, but the basic business premise has remained the same.

1.2. Recourse Loans. In general, unless specifically stated otherwise, a promise to pay a debt is fully recourse to the maker. The debt creates personal liability on the part of the maker for payment and may be satisfied out of all of the maker's non-exempt assets. Even if the loan is secured by particular assets, all of debtor's non-exempt assets, not just the assets given as security, are at risk for the payment of the debt. Recourse lending is still the norm for some types of real estate transactions such as residential and construction lending. Indeed, when I started practicing law most commercial loans were fully recourse. In this recourse lending world, Lenders made loans based on their relationship with the Borrower and the Borrower's perceived creditworthiness [expertise, balance sheet, credit history] and with the expectation that the Lender would hold and service the loan for its duration. Lender and Borrower negotiated each loan based on many factors unique to the particular Borrower and property securing the loan and the Lender made the lending decision based primarily on the Borrower's individual "creditworthiness" with respect to repayment. Because a large part of the Lender's underwriting was based on the financial attributes of the particular Borrower, loans typically had either full or partial recourse components. *Mortgage Securities: A Strategy for Originating Conduit Loans*, 29 Mortgage and Real Estate Executives Report 16 (1996).

1.3. Issues with Recourse Loans. Relationship lending, however, has many issues (such as limited access to credit and illusory creditworthiness). The problem with relationship lending's emphasis on the Borrower's creditworthiness was highlighted by the savings and loan crash of the 1980s. After the crash, it became apparent that many Borrowers had guaranteed loans which, in the aggregate, greatly exceeded their net worth. After a Borrower has guaranteed loans in excess of its net worth, all excess loan liability is effectively non-recourse. Spencer Kagen, a director in the commercial real estate group at Standard & Poor's, stated that an overreliance on borrower quality lead to some of the excesses of the 1980s. "It gets back to relationship lending, when people were lending more on relationships than assets," he said. "We had borrowers that were pledging their guaranty to the point where they weren't worth anything. Much of the type of underwriting done today is a reaction to the problems that relationship lending caused." *See* Mercel Mortgage Alert, November 25, 1996, Harrison Scott Publications, Page 7. Because of the

[1] See e.g. "*Negotiating Carve-Outs to Loan Non-Recourse Provisions (Lender's and Borrower's Perspective)*" Southern Methodist University School of Law, January 1997; *Selected Issues in Loan Documentation (Negotiating and Drafting Carve-Outs To Non-Recourse Loan Provisions)* State Bar of Texas' Advanced Real Estate Drafting Course 2001

excesses of the 1980s, Lenders in the 1990s began to look more at the ability of the asset to carry the loan rather than at the guarantor or borrower's personal creditworthiness to service the loan.

1.4. Importance of Collateral. As mentioned above, the parties may specifically agree that the debt is not fully recourse but may instead agree to partially or fully limit the promise to pay so that Lender can only resort to a particular fund or source for payment pledged by Borrower as security for the Loan. In such a full or partial non-recourse transaction the value of the collateral becomes of much greater importance than the Lender's relationship with the Borrower or the Borrower's creditworthiness.

1.5. Securitization in General. Securitization is based on the ability of the asset to carry the debt rather than on the relationship of the Lender with the Borrower. In general, securitization is the process by which the income from income producing assets is used to support the issuance of new publicly traded financial instruments either collateralized by, or representing an ownership interest in, the assets. When the income producing assets are commercial mortgage loans, the securities derived from the bundle are called Commercial Mortgage Backed Securities ("CMBS"). When the CMBS are derived from a bundle of commercial mortgage loans that are to be held by a Real Estate Mortgage Investment Conduit Trust ("REMIC Trust"), the individual loans are referred to as Conduit Loans. The Lenders who originate the loans are called originators and the loans are put into the REMIC Trust pursuant to a document called a Mortgage Loan Purchase Agreement (the "MLPA"). Since the loans will be sold and not held by the Lender, the value of the assets becomes more important than the creditworthiness of the Borrower. Indeed, quick access to the asset in the event of default mitigates in favor of loaning to a single asset entity, which owns only the pledged asset, which is bankruptcy remote, and which is not creditworthy in the traditional sense.

1.6. History of Securitization. Mortgage securitization in the United States actually began as early as 1968, with the first sale of pools of residential mortgage-backed securities through Government National Mortgage Association ("Ginnie Mae"). In 1970 Ginnie Mae issued the first Federal Housing Authority ("FHA") insured multifamily pass-through mortgage pools. The Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac") soon followed with other securitized transactions of multifamily pools. Initially, lending for sale on the secondary market was the domain of these government sponsored entities or "GSEs" and was mainly limited to residential mortgages. The first issue of a private non-agency, non-multifamily mortgage-backed security was an office building mortgage by Penn Mutual Life Insurance Company in 1984. See "*Securitization of the U.S. Mortgage Market: Progress and Pitfalls, with Lessons for Japan*," Abstract of Presentation for the Seventh Annual International Land Policy Forum, October 31, 2000, Kerry D. Vandall.

1.7. The RTC. Around 1991 the Resolution Trust Corporation ("RTC") used the securitization technique to realize on mortgages it had inherited from failed thrifts. The volume of commercial mortgages being securitized by the RTC forced the markets to address securitization issues for commercial real estate. By the time the RTC ceased operations, an active securitization market