



NON-RECOURSE CARVE-OUT PROVISIONS IN MORTGAGE LOAN DOCUMENTS – A TRAP FOR THE UNWARY

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The current economic upheaval in the real estate markets has fostered much litigation focusing on typical commercial lending practices that might otherwise have remained unexamined by the courts. One such practice involves various exceptions to, or “carve-outs” from, the “non-recourse” provision found in many commercial mortgage loan documents – a provision under which the lender agrees not to seek recourse against the borrower or its principals personally if the loan goes into default. These exceptions are triggered only if the borrower violates one of a number of pre-negotiated conditions.

Although non-recourse carve-out provisions have been used by lenders for several decades, the willingness of courts to enforce them was not addressed until recently. These recent decisions suggest that the provisions are indeed enforceable – and might even result in significantly greater exposure for the borrower (as well as for any guarantor of the borrower’s liability for carve-out provision violations) than mere compensation to the lender for those losses that are directly attributable to the violated condition.

THE EVOLUTION OF NON-RECOURSE CARVE-OUT PROVISIONS

Before non-recourse carve-out provisions became typical features of commercial lending, borrowers under non-recourse loans faced little or no personal liability for breaches of their loan covenants, aside from potentially losing the mortgaged property. In the early 1990’s, however, following the savings and loan crisis, lenders realized that true non-recourse loans left borrowers with little personal stake in their properties when economic conditions soured. In many cases, borrowers could escape or delay foreclosure indefinitely through bankruptcy proceedings or other legal tactics, and faced little exposure for activities regarding the property bordering on (to be charitable) abuse and fraud.

To combat such practices, lenders began enumerating certain prohibited acts that, if committed, would result in personal liability against an otherwise exculpated borrower or a guarantor. Initially, these carve-out provisions typically addressed common “bad boy” acts – representing clear misdeeds on the part of the borrower – such as waste, fraud, misapplication of insurance proceeds and similar intentional conduct that injures a lender. Increasingly, lenders have also attempted to carve out liability for acts that are not intrinsically wrongful, but typically complicate or delay the lenders’ ability to foreclose a mortgage, such as unauthorized subordinate financings and transfers of the property or interests therein.

In recent years, the unprecedented level of distress in the real estate markets has led to a significant increase in lender ingenuity in expanding recourse liability – leading some to question whether the exceptions have now come to swallow the rule. Personal liability of borrowers or guarantors may now arise under carve-out provisions due to unforeseen environmental issues, due to circumstances resulting in increased expense in seizing or protecting the value of a property and, importantly, where a borrower contests foreclosure or institutes a voluntary filing for bankruptcy.

The devaluation of real estate collateral has also led lenders to enforce more vigorously “full recourse liability” carve-out provisions. The traditional carve-out provision simply allowed the lender to collect damages against its borrower and any guarantor sufficient to compensate the lender for its loss due to the particular act or omission that triggered the carve-out provision. For example, if a borrower impermissibly distributed insurance proceeds to its principals, rather than using them to restore the mortgaged property or to pay down the debt, the borrower and guarantor would become liable for the amount of the converted proceeds.

Today, many loan carve-out provisions are considered “full recourse”, meaning that the borrower and guarantor become personally liable for the entire amount of the outstanding debt from the date of the default onward, regardless of the amount of the damages directly suffered by the lender as a result of the predicate default. When challenging such provisions, borrowers have typically attempted to frame full recourse liability as an unenforceable penalty, imposing exposure that is unrelated to the actual amount of the loss or damages sustained by the lender. However, to the extent that such provisions have been addressed by the courts, they have generally been held to be enforceable.

THE PRINCETON PARK DECISION

In a sign of where the law on this issue may be headed, one New Jersey appellate court has taken the concept of full recourse liability one step further – validating the use of a non-recourse carve-out provision to impose personal liability against a borrower and its guarantors for the full amount of the mortgage debt even where the breach that triggered the provision had no effect at all on either the lender or the mortgaged property. The case, *Princeton Park Corporate Center, LLC v. SB Rental I, LLC*, arose out of a \$13.3 million non-recourse mortgage loan that contained a carve-out provision stipulating that the loan would become fully recourse if, among other acts, the borrower encumbered the property with subordinate financing without the lender’s prior approval. Some time after obtaining the loan, the borrower took out a \$400,000 second mortgage on the property without receiving such approval, thus triggering the carve-out provision and creating full-recourse liability.

Had the lender sought to foreclose its mortgage against the property while the subordinate financing remained outstanding, there would have been little question regarding the imposition of personal liability under the carve-out provision. However, in *Princeton Park*, the second mortgage was fully paid and satisfied against the property some eighteen months before the borrower stopped making its payments on the first mortgage, which led ultimately to the foreclosure.

In its defense to full personal liability on the debt, the borrower attempted to characterize the carve-out provision as an unenforceable penalty or liquidated damages provision,

arguing that the breach of the covenant not to further encumber the property bore no relationship to the eventual foreclosure of the mortgage or the deficiency on sale suffered by the lender. The court rejected this characterization, finding that the actual damages suffered by the lender as a result of the breach constituted the entire amount remaining outstanding on the loan at the time of the breach.

Nor did curing the breach that triggered personal liability in the first place render enforcement of the carve-out provision unfair. In the court’s view, the fact that the subordinate financing had been paid off prior to the default under the first mortgage did not alter the fact that the borrower breached an obligation identified by both parties as posing a special risk to the lender, and therefore requiring special protection. Indeed, even *risking* the loss of the collateral securing a loan was sufficient to hold the borrower personally liable where such an outcome was clearly provided for in the loan documents.

CAUTION ADVISED ON THE PART OF BORROWERS

After the line of decisions culminating in *Princeton Park*, borrowers would well be advised to pay careful attention to all aspects of the non-recourse carve-out provisions contained in their mortgages. With the rise in commercial mortgage defaults in recent years, lenders have become increasingly wary in drafting such provisions, and have been willing to use them aggressively to pursue borrowers personally when loan collateral proves insufficient to discharge the foreclosure judgment. At least in New Jersey, and likely in other jurisdictions as well, the specific bad act committed by the borrower might ultimately have nothing to do with the mortgage loan default itself, and might cause the lender no loss or damages, yet result in full liability for the amount of the loan.

If you are among the few fortunate people holding a commercial mortgage loan commitment, or are concerned about the provisions of an existing mortgage loan, please contact us. Cozen O’Connor real estate and finance attorneys have been called upon frequently to represent prospective borrowers in negotiating the terms of their mortgage loans, as well as existing borrowers and lenders seeking advice about handling distressed loans, including those involving non-recourse carve-out provisions.