

Commercial Property - USA

No Second Chances for 'Bad Boys': Court Holds Non-recourse Carve-Out Enforceable

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Introduction

Commercial real estate mortgage loans are often made without personal recourse liability to the borrower or its principals. In that type of loan transaction, the lender may foreclose and take over the mortgaged property, but may not recover from assets other than the mortgaged property. Without such recourse, lenders may be concerned that a borrower will not act in the best interests of the collateral. Historically, in general, lenders did not worry much about this because, at least with respect to the collateral, the interests of the borrower and the lender were parallel. Things changed in the mid-1990s with the advent of securitization and the entry onto the scene of Wall Street. The recession of the early 1990s showed that borrowers were not afraid to enter into bankruptcy to stave off foreclosure and to take actions adversely affecting the value of the collateral when a foreclosure became imminent.

The rating agencies and lenders seeking access to the public markets discovered the potency of guaranties. By identifying certain actions or events that pose special risks to timely realization upon real estate collateral, real estate lenders developed 'non-recourse' or 'bad-boy' guaranties to carve certain acts out from the non-recourse liability - that is, while the loan may generally not be recourse to the borrower or its principals, certain matters may result in recourse liability for the borrower or its principals. Such non-recourse carve-outs may include:

- the occurrence of a voluntary bankruptcy;
- the further encumbrance of the lender's collateral; or
- transfers of ownership without the consent of the lender.

In its recent decision in *CSFB 2001-CP-4 Princeton Park Corporate Center, LLC v SB Rental I, LLC*⁽¹⁾ a New Jersey appellate court addressed the enforceability of a non-recourse carve-out provision in a guaranty of the senior loan which imposed full recourse liability upon principals of the borrower in the event that the borrower permitted the encumbrance of a commercial real estate asset by a second mortgage without the prior written consent of the first mortgage lender.

Facts

In *Princeton Park* a lender made a mortgage loan evidenced by a promissory note from the borrower and secured by a first mortgage on the borrower's property. The loan was further secured by a guaranty executed by three principals of the borrower in favour of the lender. The loan documents provided for non-recourse liability, but imposed personal recourse liability to the extent that the debt would be fully recourse to the borrower and the guarantors if the borrower failed to obtain the lender's prior written consent to any subordinate financing encumbering the mortgaged property. During the term of the loan the borrower obtained subordinate financing and granted a second mortgage on the property without obtaining the first lender's consent. The subordinate loan was fully satisfied during the term of the first mortgage loan, but the second mortgage was not timely discharged of record.

The borrower then defaulted under the first loan. The lender instituted a foreclosure action, which was uncontested. The mortgaged property was sold at a sheriff's sale but the proceeds of the sale were less than the outstanding amount due to the lender under the first loan. The lender then sued the borrower and the guarantors for the deficiency and moved for summary judgment seeking full recourse liability against the

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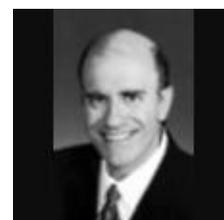
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borrower and the guarantors based on the subordinate financing default. The borrower and the guarantors argued that the non-recourse carve-out provision was an unenforceable penalty because the lender was not harmed by the encumbrance and the breach was unrelated to any damages suffered by the lender. The lower court judge disagreed with the borrower and the guarantors, and held that the damages claimed by the lender were neither speculative nor estimated, but actual and fair.

On appeal, the borrower and the guarantors argued that the non-recourse carve-out provision was unenforceable as a liquidated damages provision because the penalty from the breach bore no reasonable relationship to the harm suffered by the lender. The Appellate Division of the New Jersey Superior Court disagreed with the borrower and the guarantors and affirmed the lower court's decision.

Decision

The court held that a non-recourse carve-out provision is not an unenforceable liquidated damages provision. A provision is a liquidated damages provision, according to the court, if the actual damages from a breach are difficult to measure and the stipulated amount of damages is a reasonable estimate of the provable injury resulting from such breach. In this case, the court held the non-recourse carve-out provision was distinguishable from a liquidated damages provision because (i) the non-recourse carve-out provision defines personal liability, while a liquidated damages provision affixes probable damages, and (ii) the non-recourse carve-out provision provided for only actual damages (the outstanding loan amount), while a liquidated damages provision tries to estimate damages.

The court also indicated that the non-recourse carve-out liability was enforceable regardless of whether the lender realized a harm or whether the breach was cured because the carve-out was the bargained-for agreement of the parties and the encumbrance had the potential to affect the lender's collateral. The court stated that:

"the fact that such potential may not have actualized does not diminish the breach of obligation nor vitiate its contracted-for consequences. Having freely and knowingly negotiated for the benefit of avoiding recourse liability generally, and agreeing to the burden of full recourse liability in certain specified circumstances, defendants may not now escape the consequences of their bargain."

The non-recourse carve-out, according to the court, was clearly written and negotiated between sophisticated businesspeople. Furthermore, the court believed that the borrower and the guarantors agreed to the non-recourse carve-out and knew that it was a material term in obtaining the loan.

Comment

Princeton Park illustrates the potential liability exposure that faces borrowers and their principals should they fail to comply with non-recourse carve-out provisions. *Princeton Park* is important because the proscribed act did not create actual damage to the senior lender; yet the court upheld the benefit of the bargain, essentially saying that the right to non-recourse liability was conditioned upon satisfaction of articulated requirements, and when those conditions failed, the right to non-recourse protection failed. Therefore, it is important for borrowers and guarantors to understand and comply with all non-recourse carve-out provisions in an otherwise non-recourse loan.

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Endnotes

(1) 2009 WL 2431530 (NJ Super AD).

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