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Godzilla Lives! Or, Nonrecourse Careveouts Run Amok

MARSHALL TRACHT

The author of this article discusses two recent cases which deal with unconditional liability on nonrecourse carveouts and springing guaranties. One potential consequence of these decisions: by essentially converting these contingent guaranties to unconditional guaranties, the threat of springing liability disappears and the guaranties cease to have deterrent effects. If the guarantor is liable whether or not the single purpose entity files for bankruptcy, why not file? The result is likely to be bankruptcy filings and other "misbehavior" by borrowers. Moreover, the analysis used in these cases would put many performing loans into default along with triggering recourse, threatening substantial harm to borrowers and lenders alike.

There is a monster stalking American real estate finance, and too many are unaware of the danger they are in. It threatens to do to the commercial real estate industry in the U.S. what Godzilla did to real estate in Tokyo. The threat? Unconditional liability on nonrecourse carveouts and springing guaranties.

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THE PLOT OF THE STORY

Our story begins with any typical securitized nonrecourse mortgage. Pursuant to the rating agency standards, a nonrecourse mortgage is accompanied by nonrecourse carveouts backed by a guaranty, or by a springing guaranty. These provisions are designed to impose liability on the real parties behind the single purpose entity ("SPE") borrower if they cause the borrower to "misbehave," (that's why these agreements are commonly referred to as "bad boy guaranties"). Although precisely what constitutes "misbehavior" varies to some extent, these deals all include single purpose entity, bankruptcy remote, and nonconsolidation provisions dictated by the rating agencies.

What they have in common is that neither the guarantors nor the lenders expect these guaranties to be enforced; their job is to ensure that the borrower does not contest a foreclosure or file a bankruptcy proceeding if it defaults and that the borrower does not get caught up in any bankruptcy filed by the developer or investors. They enforce the basic understanding on these nonrecourse mortgage loans: the lender bears the risk of the property declining in value below the amount of the mortgage, and it has no recourse against assets other than the mortgaged property as long as the borrower behaves.

This idyllic story recently took an ugly turn, however, when two monsters were born in Michigan courts in December, just weeks apart. The first is a decision from the United States District Court for the Eastern District of Michigan, in *51382 Gratiot Avenue Holdings, Inc. v. Chesterfield Development Company*.[1] The second is a decision of a Michigan state appellate court in *Wells Fargo Bank, N.A. v. Cherryland Mall*.[2]

CHESTERFIELD

The *Chesterfield* case concerned a $17 million nonrecourse loan secured by the Chesterfield Village Square shopping center. John Damico guaranteed the obligations of the borrower/SPE, and was therefore on the hook for any nonrecourse carveouts in the loan documents.

In 2009, the borrower defaulted. The lender foreclosed then brought suit against Damico for a $12 million deficiency. The lender's claim? That one of the nonrecourse carveouts had been triggered by the borrower's insolvency.

"UNAMBIGUOUSLY" WRONG

There is obvious support for this position, wrong though it is, in the language of the agreements. In *Chesterfield*, the loan documents provided that the nonrecourse clause would be null and void if, among other things, the borrower "fails to comply with any provision of section 4.2 of the Security Instrument." Section 4.2(j) states that the borrower shall not "become insolvent or fail to pay its debts and liabilities from its assets as the same shall become due." Thus, the court found, when the borrower became insolvent (the mortgage debt exceeded the value of its assets) and when it failed to "pay its debts and liabilities" by defaulting on the mortgage loan, the nonrecourse provision was null and void, and the borrower and the guarantor were liable for the full mortgage debt.

The borrower and guarantor raised numerous counterarguments: the most telling is that the plaintiff's argument essentially renders the nonrecourse provision meaningless. After all, the only time the nonrecourse provision really matters is when property is worth less than the mortgage debt and the borrower has defaulted on its payments. A variety of other arguments were put forward about the inconsistency of the court's reading with other elements of the nonrecourse carveouts, that the meanings of "debt," "liabilities," and "insolvent" are ambiguous when dealing with nonrecourse debt,[3] and so on. The court found none of these convincing.

Note, however, that the court was not required at this point to determine if these arguments were correct, merely whether the carveout provision was "capable of conflicting interpretations." In granting summary judgment, the court not only rejected the defendant's arguments but held that these arguments could not prevail no matter what evidence might later have been introduced to support them.

The court, however, at least purported to consider extrinsic evidence to see if it disclosed a "latent ambiguity." A latent ambiguity, the court explained,

> arises not upon the words of [the agreement] as looked at in themselves, but upon those words when applied to the object or to the subject which they describe. To verify the existence of a latent ambiguity, a court must examine the extrinsic evidence presented and determine if in fact that evidence supports an argument that the contract language at issue, under the circumstances of its formation, is susceptible to more than one interpretation [quotation marks and citations omitted].[4]

The defendants offered the mortgage application, the commitment letter, an affidavit from the mortgage broker on the deal, and an affidavit from the guarantor to show that the parties did not envision the guaranty being triggered by a simple monetary default on the loan or decline in the property's value. The mortgage broker, for example, stated

> that there was no personal liability of the borrower (or anyone else) in the event of non-payment of the mortgage debt. This also was both Morgan Stanley's and my intention, agreement and understanding and also was the intention, agreement and understanding that I conveyed to Chesterfield and Mr. Damico.

The court found that even such express testimony that the provision was not intended to act as the court believed it did, did not create an ambiguity:

> [T]he extent of the Defendants' personal liability under the Loan Agreement is not a collateral matter than could give rise to a latent ambiguity; rather it is a function of the terms of the contract. As already determined, those terms unambiguously provide that a failure to make Loan payments as required ... nullifies [the nonrecourse provisions]. Extrinsic evidence cannot be used to vary unambiguous contract language.[5]

This is circular reasoning at its best: The court will examine extrinsic evidence to determine if there is a latent ambiguity, but because the court has already determined that the language is unambiguous, the "extrinsic evidence cannot be used to vary" it.

The court noted the argument that this ruling would have terrible consequences for the real estate industry, but neither credited the prediction nor found that it would affect its analysis of the parties' contract. In the end, the court concluded that "[r]egardless of the original, or even essential, purpose of the type of transaction that Defendants wished to enter into with Morgan Stanley, they are bound by the terms of the Loan Agreement they actually signed."

This is a key point: even if both parties intended that there be no personal liability in the circumstances at bar, the court held, their actual intent cannot control over the "unambiguous" words of the document.

Of course, if the parties intended something other than what was written, this might seem like cause for reformation of the agreement to reflect their actual intentions, but apparently not:

> At most, the evidence Defendants present shows that, though both they and Morgan Stanley intended to be bound by the terms of the Loan Agreement, both parties misunderstood the legal effect of the terms contained in that agreement.... [W]hen parties make "mistakes regarding the legal effect of the contract actually made," that contract "will seldom, if ever, be relieved against unless there are other equitable legal features calling for the interposition of the court."[6] There are no equitable considerations in this case that urge the court to reform the Loan Agreement or otherwise relieve Defendants of their obligations under it, as Defendants are sophisticated parties who had the benefit of counsel when executing into the Loan Agreement.

A review of Michigan law on reformation shows that the court is wrong on this point. As the Michigan Supreme Court has said, "[i]f reading a written instrument (which both parties thereto admit did not express their intention) precludes reformation thereof on the ground of mutual mistake, then we wipe out hundreds of years of equity and elevate the scrivener to the ermine ... [T]he chancellor does indeed concern himself with the intent of people. Specifically, ... he will amend an instrument to represent the actual agreement of the parties, *regardless of the content of the parchment.*"[7]

The statement that there must be some "other equitable legal features calling for the interposition of the court" applies where the mistake is only as to the "legal effect of the contract actually made," not when the writing fails to reflect the "contract actually made" — that is, the actual terms of the agreement to which the parties assented.[8]

The mistake here is not about the legal effect of a term, but the drafting of a term that failed to reflect the actual intent of the parties as to the basic economic allocation of risks and rewards in the transaction. Such a mistake must be corrected if contract law is to accomplish its basic function of carrying out the mutual intent of the parties.

This is in keeping with the view of the Restatement (Second) of Contracts, Section 155:

> Where a writing that evidences or embodies an agreement in whole or in part fails to express the agreement because of a mistake of both parties as to the contents or effect of the writing, the court may at the request of a party reform the writing to express the agreement, except to the extent that rights of third parties such as good faith purchasers for value will be unfairly affected.

CHERRYLAND

The *Cherryland* case is similar in important respects. Again, it was a suit against a guarantor for the deficiency after foreclosure on a non-recourse mortgage. The loan documents provided that the loan would become fully recourse in the event Cherryland "fails to maintain its status as a single purpose entity as required by, and in accordance with the terms and provisions of the Mortgage."

The mortgage contained a provision with the header "9. Single Purpose Entity/Separateness," raising the question of what provisions in Paragraph 9 were part of "maintain[ing] its status as a single purpose entity." In particular, subparagraph 9(f) contained essentially the same provision as in *Chesterfield*: "Mortgagor is and will remain solvent and Mortgagor will pay its debts and liabilities (including, as applicable, shared personnel and overhead expenses) from its assets as the same shall become due." According to the guarantor, subparagraph 9(f) is an element of the "separateness" covenants, and was not needed to maintain the borrower's status as an SPE.

The trial court granted summary judgment to the lender, and the court of appeals affirmed. The appellate court held that, regardless of the Guaranty's integration clause, which barred the use of extrinsic evidence "to contradict, vary, supplement or modify any term," extrinsic evidence could be consulted "to define an undefined technical term," like "single purpose entity." Referring to the Standard & Poor's U.S. CMBS Legal and Structured Finance Criteria, the court found that an SPE "is an entity, formed concurrently with or immediately prior to the subject transaction, that is unlikely to become insolvent as a result of its own activities and that is adequately insulated from the consequences of any related party's insolvency." This shed little light on the issue, of course. Ultimately, and without any real analysis of whether there is a difference between SPE and separateness covenants, the court held that all of the provisions of Paragraph 9 were elements of the borrower maintaining its status as an SPE. Again, one can wonder about the conclusion that this contractual interpretation is required as a matter of law and that the contract could be construed without remand for factual development.

Regardless, the next question was whether the provision had, in fact, been violated. The defendants argued that the insolvency provision was intended to prevent the borrower from removing assets, thus becoming unable to pay its debts, and not to deal with a decrease in the value of the mortgaged property due to market conditions. The court found, however, that the provision was not so limited, and that any failure to remain solvent was a violation. Again, the court was not unaware of the potential impact of its decision:

> We recognize that our interpretation seems incongruent with the perceived nature of a nonrecourse debt and are cognizant of the amici's arguments and calculations that, if accurate, indicate economic disaster for the business community in Michigan if this Court upholds the trial court's interpretation. Nevertheless, the documents at issue appear to be fairly standardized nationwide, and defendants elected to take that risk, as did many other businesses in Michigan and na-

> tionwide. It is not the job of this Court to save litigants from their bad bargains or their failure to read and understand the terms of a contract.

Not every argument the parties made has been parsed here, nor have the courts' analyses, in great detail, because anyone familiar with nonrecourse real estate lending knows that this simply was not the business deal the parties intended. In fact, the courts in both cases basically admitted as much.

What are the ramifications of these decisions?

WHAT NEXT?

The potential consequences of these decisions are hard to overstate. The provisions addressed in these two cases are standard terms that have been used in countless securitized and non-securitized loans.[9] It is impossible to quantify the amount of these loans, but they are clearly in the many tens or even hundreds of billions of dollars. If these decisions survive appeal, and courts in at least some other jurisdictions follow suit, the result will be disastrous for the commercial real estate industry. Among the potential effects:

- A violation of these provisions not only nullifies the nonrecourse provisions in a loan, but is an event of default in and of itself. As a result, every SPE with this form of covenant whose property is worth less than the outstanding nonrecourse debt is in default, and the lender can accelerate, foreclose and pursue the guarantor(s) unless adequate equity is invested into the SPE to cure the default. Given the current state of the real estate market, this must be hundreds or thousands of loans. This risk runs not just to the property owner and guarantors, but also to innocent tenants whose leases may be extinguished by foreclosure.
- It is possible that even if this equity were injected, a court could hold that the terms of the nonrecourse carveouts were violated because the borrower had at one point been insolvent, and thus the guarantor(s) are on the hook if the loan later defaults. Consider, for example *CSFB 2001-CP-4 Princeton Park Corporate Center, LLC v. SB Rental I, LLC*,[10] where the springing guaranty was triggered when a borrower

took out a junior mortgage without the senior mortgagee's permission. Even though the junior mortgage had been paid off and released well before the borrower defaulted on the senior mortgage, the court held that the guaranty had been triggered and the payment and release of the offending junior mortgage did not "untrigger" it.

- Lenders can go back over past foreclosures where everyone assumed the guarantor(s) were off the hook and now file suit against the guarantor(s), asserting that the springing guaranty or nonrecourse carveouts were violated. While some guarantors might have defenses under antideficiency statutes, statutes of limitations, or arguments of waiver, many would not.
- Most guarantors who entered into these types of deals signed far more of these contingent guaranties than they could ever repay, understanding that they could avoid their liability by adhering to the mortgage's requirements and cooperating with the lender after default. It would only take a small number of judgments against such guarantors to render them technically insolvent and subject them to judgment liens and levies, thereby triggering defaults on their other loan agreements, bond indentures, and so forth. Indeed, even without such judgments, it is possible that an accountant or auditor would determine that, given the state of the law, these guaranties have moved from possible liabilities of indeterminate amount to probable liabilities that are currently estimable and that they therefore must be included in the guarantor's balance sheet and financial statements.
- By essentially converting these contingent nonrecourse guaranties to unconditional guaranties, the threat of springing liability disappears and the guaranties cease to have deterrent effects. After all, if the guarantor is liable whether or not the SPE files bankruptcy, why not file? The result is likely to be bankruptcy filings and other "misbehavior" by borrowers.
- Lenders lose big. These cases look like a clear win for the lenders, but in fact commercial real estate lenders and investors who have purchased CMBS stand to be major losers if these cases are followed in any number of states. If even a small percentage of these guaranties

> are enforced, many controlling parties who signed springing guaranties will find themselves (not just their SPEs) in financial straits. This will disrupt their operations, render them unable to make necessary investments in their properties, and skew their incentives from long-term value maximization to milking projects while they can — thus endangering the lenders on all of their projects, whether located in a jurisdiction that has followed these precedents or not.

The decisions in these two cases are rendered more serious by several factors. First, there do not appear to be any other cases interpreting this language, so at this point they are the only precedent on point, which will give them added weight in subsequent cases. Second, the opinions, while wrong in a number of ways, appear well researched and carefully crafted — they are not going to be easily disregarded based on careless reasoning or sloppy drafting. Third, they were decided as a matter of law, on summary judgment. If the courts had decided these agreements were ambiguous and then made factual determinations that the parties had contracted for liability on these facts, subsequent courts could follow these decisions on the law but come to different factual conclusions based on the specific documents and testimony in each case. By deciding that these agreements hold the guarantor liable as a matter of law, adherence to these decisions would preclude such arguments in subsequent cases.

All is not lost — yet. Both of these cases are still on appeal, and higher courts should recognize the inherent ambiguity (whether patent or latent) in these provisions and reject the imposition, as a matter of law, of interpretations inconsistent with the parties' intent on a term of fundamental importance to the transaction. Or, if higher courts are truly convinced that this is the only viable reading of the documents, there is hope that they will be willing to give more serious consideration to reformation of the contracts. Reformation has a high standard in most states, such as clear and convincing evidence that the agreement does not reflect the actual intent of the parties, and that is as it should be. However, stubborn adherence to a reading of the words of a contract that demonstrably violates the basic economic terms of the transaction — and the entire industry — is neither required nor justifiable. It imposes large and unexpected losses not just on the parties, but on others who have dealt with them reasonably and in good faith with an understanding of their financial condition, and on the economy as a whole. If these decisions are upheld and followed, we will all get to watch a horror movie together — one in which the monster wins.

NOTES

1 *51382 Gratiot Avenue Holdings, Inc. v. Chesterfield Development Company,* 2011 U.S. Dist. LEXIS 142404 (E.D. Mi. Dec. 12, 2011) ("Slip op.").

2 *Wells Fargo Bank, N.A. v. Cherryland Mall*, __ N.W.2d ___, 2011 WL 6785393 (Mich.App. 2011).

3 With a nonrecourse debt, the obligation of the borrower is limited to the lesser of the amount of the debt or the value of the collateral. Thus, it could sensibly be argued that if the property drops in value below the debt, the liability drops commensurately. In this case, solvency is determined by whether the borrower's nonmortgaged assets are adequate to pay nonmortgage debts. In fact, this coincides with the intent of bankruptcy remote provisions, to reduce or eliminate the possibility of third party creditors who might file an involuntary proceeding. This is also in keeping with general accounting principles, that a contingent liability is only included in net worth if the loss is probable, not just because it is possible.

4 Slip op. at 26.

5 Slip op. at 27.

6 *Citing Johnson Family*, 761 N.W.2d at 363 (quoting *Schmalzriedt v. Titsworth*, 305 Mich. 109, 9 N.W.2d 24, 28 (Mich. 1943)).

7 *Id.* at 372-373 (quoting *Urick V. Burge, 350 Mich.* 165, 86 N.W. 543 (1957)). (Emphasis in original.)

8 *Id*. at 363 (quoting *Schmalzriedt v. Titsworth*, 305 Mich. 109, 119-120, 9 N.W.2d 24 (Mich. 1943)).

9 This provision can be found in numerous published forms from leading practitioners over a substantial period of time. A quick search on one computerized database discloses this language in the 2011 edition of a major form book, in a sample document in a 2005 PLI coursebook, and in another, a 1998 PLI coursebook. It is clear that these provisions are common, but impossible to tell just how many loans — and how many dollars — are at stake.

10 410 N.J. Super. 114, 980 A.2d 1 (N.J.Super.A.D. 2009).