

## Testing the Limits of Recourse Carve-Out Guaranties

Non-recourse loans with certain recourse obligations guaranteed by affiliates of the borrower have been a fixture of commercial real estate lending since the late 1990s. Recourse carve-out guaranties often provide that if the borrower commits certain bad acts, the guarantor may be held personally liable for lender's losses or the entire loan. The loan documents expressly define the bad acts and limit the borrower's, and thus the guarantor's, scope of personal liability to these bad acts. Typically, loan documents divide these bad acts into two categories: those bad acts that give rise to "loss recourse," in which case the guarantor is liable for lender's losses arising out of the borrower's bad acts; and those bad acts that are "fully recourse," in which case the guarantor is held personally liable for the entire amount of the loan.

Several recent cases have tested the validity and scope of recourse carve-out guaranties in the non-recourse commercial real estate loan context. The decisions addressed the validity of recourse carve-out provisions and whether a borrower or guarantor can be held liable for acts outside of the scope of the carve-outs set out in a guaranty. In these recent cases, each court that analyzed the recourse carve-out provisions enforced the plain language of the agreement. However, while those courts generally upheld the validity of recourse carve-out provisions, they did not expand their scope beyond the provisions of the guaranty. In each case, the guarantor's liability was determined by the express terms of the agreement. While the overwhelming majority of recent cases were decided consistently with the precedents discussed here, lenders should be cautioned that bankruptcy courts may under certain circumstances utilize their broad equity powers to stay actions against guarantors, especially in

situations where the creditors are deemed fully secured and the enforcement of the guaranties is deemed to be detrimental to the debtor's reorganization efforts, as illustrated in the injunction motion ruling in the *In re: Bray & Gillespie Management LLC*<sup>1</sup> case.

The most prominent recent case to address the issues raised by recourse carve-outs is *Blue Hills Office Park LLC v. J.P. Morgan Chase Bank*.<sup>2</sup> However, several recent cases have addressed very important issues, including recourse carve-outs that are triggered by bankruptcy filings. The following discusses these cases.

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<sup>1</sup> *In re: Bray & Gillespie Management LLC*, No. 3-08-BK-05473-JAF (Bankr. M.D. Fla. 2008)

<sup>2</sup> 477 F. Supp. 2d 366 (D. Mass. 2007).

## The *Blue Hills* Decision

In September 1999, Blue Hills Office Park LLC (“Blue Hills”), the borrower, obtained a \$33,149,000.00 non-recourse loan secured by a mortgage on a commercial property. The individual trustees of Blue Hills’ parent company, Royall Associates Realty Trust (the “Guarantors”), executed a recourse carve-out guaranty in favor of the lender. The loan was later securitized.

At issue were Blue Hills’ actions in 2003. Without notifying or receiving the consent of the holder of the loan, as required by the loan documents, Blue Hills settled a zoning dispute with a neighboring property. As part of the settlement, Blue Hills received \$2,000,000. Blue Hills wired the settlement proceeds to a trust account at its law firm, did not notify the holder of the loan of its receipt of the funds and failed to turn over the money to it. Blue Hills later defaulted on the loan by not making a real estate tax payment, resulting in acceleration of the loan and foreclosure sale of the property. The holder of the loan demanded the full deficiency from the Guarantors, which they refused to pay.

In response to the deficiency claim, Blue Hills filed suit in the United States District Court for the District of Massachusetts against the holder of the loan claiming breach of contract, breach of covenants of good faith and fair dealing, and violations of Massachusetts general law related to the engagement in unfair business practices.

In response, the lender filed a countersuit against Blue Hills and the Guarantors alleging that Blue Hills breached the loan agreement and the implied covenant of good faith and fair dealing, made intentional misrepresentations, violated Massachusetts general law, and, due to the Borrower’s failure to notify the lender of the zoning settlement and failure to turn over funds, that the Guarantors were liable under the guaranty pursuant to the provisions of the guaranty that imposed full personal liability for the entire loan in the event: (i) the borrower failed to obtain the lender’s consent to any assignment, transfer, or conveyance of the mortgaged property; or (ii) the borrower failed to maintain its status as a special purpose entity (“SPE”) and comply with related covenants. In particular, the mortgage contained a covenant that Blue Hills not commingle funds. Massachusetts law governed the loan documents and guaranty.

The Guarantors argued that Blue Hills’ failure to notify the lender of its receipt of settlement proceeds and failure to turn the proceeds over to the lender should

have been properly classified as giving rise to personal liability only for lender’s losses due to such conduct but not liability for the entire loan. Moreover, the Guarantors argued that because the conduct causing loss recourse liability was more severe than the conduct causing full recourse liability, the Guarantors could not be held fully liable for the entire loan. The court rejected this argument because the guaranty clearly stated that the Guarantors would be held fully liable for the loan based on the acts Blue Hills committed regardless of other provisions relating to “loss recourse.”

In analyzing whether the Guarantors were subject to limited or full recourse based on Blue Hills’ actions, the court held that the “plain language of the contract governs.” Using basic rules of contract interpretation, the court held that Blue Hills’ transfer of the settlement proceeds without lender’s written consent was a transfer of mortgaged property, in violation of the loan documents for which the Guarantors were personally liable under the full recourse provisions of the guaranty.

The Guarantors were also held personally liable for the entire loan because Blue Hills violated its SPE status. The court found that Blue Hills violated several express covenants in the mortgage designed to protect the lenders, including requirements that Blue Hills not commingle funds or assets with those of anyone else and that Blue Hills at all times have an independent director, thereby creating personal liability for the full amount of the loan.

Although the court held the Guarantors liable for the entire outstanding balance of the loan, it did so only because the express terms of the guaranty provided for such a result. The *Blue Hills* decision both upheld the validity of recourse carve-out guaranties and limited their scope to the express terms of the agreement.

## Recent Cases Following *Blue Hills*

Recent cases decided after *Blue Hills* have affirmed the *Blue Hills* court’s general ruling that recourse carve-out provisions are enforceable and that borrowers and guarantors will only be found liable based on the express provisions of the agreement. The following is a brief summary of several of these cases.

***CSFB 2001-C-4 Princeton Park Corporate Center, LLC v. SB Rental I, LLC*<sup>3</sup>**

The court, citing *Blue Hills*, upheld the validity of recourse carve-out guaranties in the state of New Jersey. The court held that a recourse carve-out guaranty is not a liquidated damages provision and, therefore, not an unenforceable penalty. In this case, the borrower violated a provision in the loan documents that required the borrower to obtain the written consent of the lender before allowing a subordinate lien on the property, making the guarantors fully liable under the loan pursuant to the recourse carve-out guaranty. The subordinate lien was a \$400,000 second mortgage on the property. In reaching this decision, the court held that the terms of the guaranty were clear, and that the guaranty had been negotiated by sophisticated parties. The court, therefore, enforced the express terms of the guaranty.

***GCCFC 2006-GG7 Westheimer Mall, LLC v. Edward H. Okun*<sup>4</sup>**

The case was decided under New York law in the United States District Court for the Southern District of New York. The court found that the carve-out guarantor under the non-recourse loan was liable for the full amount of the loan under the guaranty in favor of the holder of the loan, due to the borrower's filing a voluntary petition for bankruptcy, which, pursuant to the terms of the recourse carve-out guaranty, imposed full personal liability for the loan. Because the borrower filed for bankruptcy, the court granted summary judgment in favor of the lender and found the guarantor personally liable for the outstanding indebtedness. Although the court found the guarantor liable for the entire loan, the court only looked to the plain language of the contract in making its ruling. The court, therefore, enforced the express terms of the guaranty.

***111 Debt Acquisition LLC v. Six Venture, Ltd.*<sup>5</sup>**

This case was decided under Ohio law in the United States District Court for the Southern District of Ohio. The court held that under the guaranty, the guarantors were liable if borrower violated the recourse carve-out provisions in the loan agreement. The guaranty combined with the loan agreement provided that if the

<sup>3</sup> 2009 N.J. Super. LEXIS 199 (N.J. Super. Ct. App. Div. 2009).

<sup>4</sup> 2008 U.S. Dist. LEXIS 64152 (S.D.N.Y. 2008).

<sup>5</sup> 2009 U.S. Dist. LEXIS 11851 (E.D. Ohio 2009).

borrower filed for bankruptcy, the guarantors would be personally liable for the full amount of the loan, which provision the court upheld. In particular, the guaranty itself stated that the rights of the lender to enforce the guaranty would not be affected by a bankruptcy filing by the borrower or guarantor. The court reached this conclusion by following the rule that the interpretation of a guaranty is identical to the interpretation of a contract. Because the guaranty was clear and unambiguous, the court looked to the express terms of the agreement in reaching its conclusion.

***Diamond Point Plaza Limited Partnership v. Wells Fargo Bank, N.A.*<sup>6</sup>**

The Court of Appeals of Maryland held that, because the borrower violated the express full recourse carve-out provisions of the loan agreement, the guarantors under the loan agreement were liable for the entire balance of the loan under Maryland law. The borrower violated two alternative full recourse carve-out provisions in the loan agreement: (i) the misapplication or conversion of rents after an event of default; and (ii) failure to maintain its status as an SPE.

First, the court found that the borrower transferred the rents generated by the property after an event of default to an affiliate. Such transfers constituted misappropriation of rents and were the basis of full personal liability for the loan under the recourse carve-out guaranty. The court rejected the borrower's claim that the transfer was an advance rather than a misappropriation.

In the alternative, the court held that if the borrower's transfer of funds was an advance, it violated the SPE covenants by: (i) entering into an agreement that was not intrinsically fair and at arms length; and (ii) making a loan to a third party. First, the court held that the transfer was considered an unauthorized loan, in violation of the borrower's SPE covenants, causing the guarantors to become fully liable under the recourse carve-out guaranty. Second, the transfer to an affiliate was not documented by a note expressing clear repayment terms and, therefore, was not intrinsically fair or available in an arms length transaction. In both cases, because the borrower violated the SPE covenants under the loan agreement, the borrower failed to maintain its SPE status and the guarantors were liable for the entire outstanding indebtedness.

In making its decision, the court looked to the express terms of the agreement and concluded that the

<sup>6</sup> 929 A.2d 932 (Md. 2007).

borrower's actions fell squarely within the full recourse carve-out provisions of the guaranty.

## Significance of the Cases and Other Precedents

The decisions in *Blue Hills* and other recent cases analyzing recourse carve-out guaranties in non-recourse commercial real estate loans bring some comfort to both lenders and borrowers. With limited exceptions, none of which gave rise to published opinions, the courts have consistently protected lenders by enforcing recourse carve-out liability in instances where borrowers have violated express recourse carve-out provisions. In the recent cases, the courts have protected borrowers,

however, by not expanding the scope of recourse carve-outs to bad acts not expressly covered by the agreement. In none of the recent cases did the court impose personal liability on a borrower or guarantor for any act not specifically defined within the agreement. Both borrowers and lenders, therefore, can take comfort in these facts.



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