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Legal Briefs

Carveout Consequences

Learn how the courts rule on non-recourse loan provisions.

by Chris K. Safarian, JD, Alex Y. Choi, JD, and Nancy Grant, JD

In the commercial real estate market's current distressed state, mortgage lenders are faced with falling real estate values and sluggish properties that can't meet debt service obligations. Inevitably, loan documents become the roadmap for lenders seeking to recoup their losses and to assess how much of the outstanding debt they can recover.

Non-recourse provisions in loan documents often determine the route lenders must follow when dealing with troubled loans. Non-recourse provisions limit the extent to which lenders may recover repayment of loans in foreclosure sales or other property dispositions. They also prohibit deficiency judgments against borrowers or guarantors unless the deficiency is the result of an act or omission that triggers recourse liability under the loan documents. Carve-outs to non-recourse loan provisions influence lenders' decisions to recover deficiencies from borrowers and encourage borrowers to preserve the collateral's value.

In today's market, it's critical for lenders and borrowers to consider the enforceability of recourse carve-outs negotiated by both parties. A brief look at court rulings illustrates the legal consequences that can result from not understanding the potential pitfalls associated with recourse carveouts.

Enforcing the Provisions

In *FDIC v. Prince George Corp.*, the court enforced a recourse carveout triggered by a voluntary bankruptcy filing. The promissory note prohibited the borrower from voluntarily becoming part of a case, action, suit, or proceeding, which suspended, reduced, or impaired the lender's recourse rights to the collateral. Despite the recourse carveout, the borrower filed a bankruptcy petition four days before the foreclosure sale. The court held that the bankruptcy filing violated the clear terms of the note since the stay of the foreclosure sale directly impaired the lender's rights to the collateral.

Although the borrower argued that the note's provisions interfered with its right to file for bankruptcy, rendering the provision void as against public policy, the court countered that the note merely provided that if the borrower took certain actions, it would forfeit its exemption from liability for any deficiency.

Courts also have upheld recourse carveouts triggered by acts that devalue the collateral. For example, in *D.A.N. Joint Venture v. Binafard*, when a borrower under an \$8 million note secured by a jewelry center elected to make only those repairs necessary to keep its property open and operational, the jury found that the borrower owed \$2.8 million in damages based on its waste of the collateral. In a similar case, *Nippon Credit Bank v. 133 North California Boulevard*, recourse liability was triggered when the borrower failed to pay real estate taxes in violation of applicable laws and the loan document terms.

In addition, inaccurate or incomplete disclosures regarding the property or its operation also may result in personal liability for borrowers and/or guarantors. For example, in *Diamond Point Plaza LP v. Wells Fargo Bank*, a shopping center borrower made ongoing representations about the property in the borrower's certificate, which included the standard requirement to advise the lender if any part of the certificate became untrue. The borrower and related entities were found personally liable for failing to reveal the planned departure of a Sam's Club, a tenant that served as collateral for the refinancing.

The Pitfalls

Despite the fact that courts have upheld carveouts to non-recourse provisions, there still are potential pitfalls to consider when negotiating or undertaking the enforcement of recourse carveouts.

No Blanket Immunity. The absence of a particular recourse carveout does not necessarily provide absolute immunity for borrowers. In spite of non-recourse language in loan documents, lenders have successfully sued and recovered from borrowers who committed waste or defrauded the lender. In *D.A.N. Joint Venture*, the loan documents didn't need to expressly forbid waste of the property, since, under California law, a borrower may not substantially impair the lender's security.

Therefore, borrowers should be aware that committing any bad acts may expose them to personal liability, regardless of whether or not such acts trigger recourse liability under the loan document terms.

Clarity and Specificity. Although recourse carveouts appear generally enforceable, borrowers and lenders should carefully heed provisions that describe both the property and the events that trigger liability. In *U.S. Bank v. American Realty Trust*, the lender, relying on broad language requiring the borrower to operate its businesses presently conducted, sued for waste of the security property when the borrower changed the hotel flag from a Holiday Inn to a Clarion Hotel. The court determined that the loan documents merely required the borrower to operate the property as a hotel, not as a Holiday Inn. Thus, lenders always should include concerns specific to the particular property that might impair the collateral value.

Full Recourse Liability Versus Losses. Loan documents generally dictate whether violation of the recourse carveouts permit the lender to recover the entire loan balance or merely the specific amount of loss the lender incurred, resulting from such violation. While there has been little case law regarding the enforceability of provisions triggering recourse liability to the borrower for the entire loan amount, *Blue Hills Office Park LLC v. J.P. Morgan Chase Bank* provides a cautionary tale. In *Blue Hills*, the borrower, who violated the loan document terms by failing to disclose a \$2 million zoning settlement, obtain the lender's consent to settle the case, and maintain the single-purpose entity requirements, and diverting settlement funds to itself, was found personally liable for the loan's full amount, not just the \$2 million in restitution.

However, if the borrower in *Blue Hills* instead had diverted a \$2,000 settlement, the court may have viewed the recourse for the full loan amount as a penalty and limited the recovery. Overall, lenders should consult with their attorneys to craft language that best preserves the lenders' interests.

Based on current case law, courts generally will enforce carveouts to non-recourse loan provisions. Commercial real estate investors, borrowers, and guarantors always should review the recourse carveouts of their loan

documents to avoid committing any seemingly innocuous acts that could forfeit the loan's non-recourse nature.

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