NEGOTIATING NON-RECOURSE CARVE-OUTS IN LIGHT OF RECENT COURT DECISIONS

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During the years 1978-91 Jim served as an adjunct professor at SMU Law School, teaching a course entitled "Real Estate Transactions." In addition, since 1975 he has spoken at and chaired various conferences and institutes, including the University of Texas Mortgage Lending Institute (Chair: 1979-1989), the State Bar of Texas Advanced Real Estate Law Course (Chair: 1989), the SMU Law School Real Estate Law Institute (Chair: 1989), the Texas Land Title Institute and programs sponsored by the American College of Real Estate Lawyers and the International Conference of Shopping Centers. He has also published three articles in the SMU Law Review.

In 1988-89 Jim served as Chair of the Real Estate, Probate and Trust Law Section of the State Bar of Texas. During 1982-96, he served as Chair of the Section's Opinion Letter Committee, and during 1985-89 he served as Chair of the Section's Committee on Legal Fees Paid by Title Companies. He is also the recipient of the Section's Distinguished Texas Real Estate Lawyer Lifetime Achievement Award.

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This presentation, while incorporating a good bit of commentary and analysis from two prior presentations [2], has become much more topical in light of recent court decisions in the area of non-recourse carve-out liability and especially what is commonly referred to as "springing" liability or recourse or "springing full" recourse or liability.

1. NON-RECOURSE LOAN CONCEPTS

1.1. Non-Recourse.

One of the common dictionary definitions of the word "recourse" is as follows: "*in business or law*, the right to demand payment from the maker or endorser of an instrument (such as a promissory note or a check)." Non-recourse, then, is the feature of some loans whereby the lender ***does not*** have "the right to demand payment from the maker or endorser." Instead, the lender receives from the borrower a pledge of collateral for the borrower's repayment of the loan; and if the borrower fails to repay the loan, the lender's recovery is limited to its obtaining the collateral, generally by foreclosure. In the event of the borrower's default on a non-recourse loan, if the value of the collateral turns out to be insufficient to satisfy the full amount of the loan balance, then the lender suffers a loss equal to the difference between the loan balance and the value of the collateral.

1.2. Carve-Outs.

A good definition of carve-outs was included in a 2011 article by John C. Murray, Vice President and Special Counsel for First American Title Insurance Company in the company's Chicago

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1 Especially in light of the admittedly editorial tone of some of the comments in this outline, I want to start the outline with the following disclosure, disavowal and apology: (1) Disclosure: The orientation of my law practice for the past twenty years has been predominantly the representation of real estate developers and investors, i.e., not mortgage lenders. (2) Disavowal: I acknowledge that the comments in this outline are solely my own personal observations and conclusions, and they in no way represent the views of Glast, Phillips & Murray or any clients of our law firm. (3) Apology: While I believe the analysis and commentary in this outline to be correct, I apologize in advance to anyone whose opinions may be different and who may be offended by the content or tone of my comments.

2 Wallenstein, *Negotiating Liability Provisions for Promissory Notes and Guaranties*, University of Texas Law School 2009 William W. Gibson, Jr. Mortgage Lending Institute; and Wallenstein, *An Updated Report and Analysis on Springing Recourse Guaranties in Mortgage Loan Transactions*, June 2011 issue of *eReport* published by the American Bar Association's Real Property, Trust and Estate Law Section. The latter article is attached as an Appendix to this outline.

National Commercial Services office in his web article entitled "Enforceability of Carveouts to Nonrecourse Loans: An Update," which can be accessed through the following web link:

http://www.firstam.com/title/resources/reference-information/jack-murray-law-library/enforceability-of-carveouts-to-nonrecourse-loans-an-update.html :

> "Since the mid-1980s, lenders have been qualifying and restricting nonrecourse provisions in commercial real-estate loans by making exceptions for certain 'bad acts' by borrowers. In recent years, many lenders have expanded the scope of such 'carveouts' to include risks of exposure to the property's economic deterioration or neglect. Some nonrecourse provisions provide that the borrower is liable for the specific damages resulting from the violation or breach of a carveout, while others state that the entire loan becomes recourse to the borrower if any of (or certain of) the excepted acts occurs. In some cases the exceptions have virtually swallowed the rule; i.e., the clause is drafted so that the borrower has personal liability for virtually all defaults except the failure to pay the principal and interest due on the loan."

NOTE: The final sentence in Mr. Murray's article indicates that although dated in calendar year 2011, the article was prepared prior to December 2011. See Section 2.2.2.B. beginning at the bottom of the next page.

2. LIABILITY LIMITATION PROVISIONS FROM THE PERSPECTIVE OF THE LENDER AND THE BORROWER

2.1. A Lender's View of Non-Recourse: License for the Borrower to "Take the Money and Run".

Although my law practice has been predominantly oriented towards developer and investor representation for the past 20 years, before that I had a considerable lender orientation to my practice. And I remember the days before non-recourse carve-outs became prevalent, when loan documents often contained absolute non-recourse provisions without any carve-outs. During that period lenders often found that borrowers with no liability under the loan documents, i.e., nothing to lose, failed to maintain properties that they anticipated losing to foreclosure, so that properties on which lenders had just foreclosed were found to suffer from what might charitably be called "deferred maintenance." In one instance during that period prior to the incorporation of non-recourse carve-outs in loan documents, I remember representing a lender who foreclosed on property only to find that a portion of the property had been condemned and the borrower had taken the condemnation proceeds in violation of the mortgage. And in another instance during that period I remember representing a lender who foreclosed on an apartment project on the first Tuesday of a month (which coincidentally was the first calendar day of the month) and who then discovered that the prior month the borrower had distributed a circular to all tenants, offering a 10% discount in the rent for the following month if the tenant paid before the end of the current month.

2.2. A Borrower's View of Recourse Carve-Outs

In my 2009 outline for the University of Texas Law School Mortgage Lending Institute (MLI), I acknowledged that some of my suggestions in that outline might appear to be "nitpick" issues. And in my experience occasionally a lender representative or a mortgage broker has in fact demonstrated impatience with borrower requests for liability clarification, assuring the borrower that the lender will not seek to undercut the non-recourse essence of the loan by asserting interpretations of the loan documents that, while possibly technically defensible, are contrary to that non-recourse essence.

2.2.1. Prior to 2011: the Fictional "Saddlebags" Story.

Even before the 2011 court decisions that I will summarize in Section 2.2.2 below, I had suggested that the borrower's attorney might give thought to the possibility that at some time in the future the borrower will not be interfacing with the same pleasant loan officer who represented the lender at the commencement of the loan transaction but instead will be facing a lender representative comparable to the "workout artiste" who was a main character in the chapter entitled "The Saddlebags" in Tom Wolfe's 1998 novel A Man in Full. In that chapter a real estate developer comes with his entourage to a meeting at his principal lending institution, where he is accustomed to receiving royal treatment as a significant customer of the lending institution for many years. However, since the developer's loans are now in a default status, his long-time loan officer has been replaced by a "workout artiste" (the term used by Mr. Wolfe throughout the chapter) who wears skull-and-crossbones suspenders and who talks to the developer as if the latter were a new recruit in Marine boot camp. In addition, instead of the customary meeting location in a luxurious conference room where coffee is served in fine china, the developer and the "workout artiste" as well their respective entourages now meet in a seedy office with a plastic laminate conference table and stale coffee served in paper cups. The chapter describes how the developer is so surprised and mortified by the meeting room environment and the badgering of the "workout artiste" that he begins to sweat. At the end of the chapter the sweat stain on the developer's shirt has become so pronounced, extending continuously from armpit to armpit, that the young bankers who are in the entourage of the "workout artiste" (and who look forward to this event every time the "workout artiste" interacts with a once-haughty borrower) silently exclaim to themselves: "Saddlebags!"

2.2.2. After 2011 and 2012 Court Decisions: "Saddlebags" Concerns are no Longer Fictional.

A. Assurances by Lender's Representative at the Start of the Transaction. As I mentioned above, it is not unusual for a lender's loan officer to assure the borrower at the start of the transaction not to worry about the language of the non-recourse carve-outs -- in other words, tell your attorney to stop nitpicking -- since, after all, those provisions won't be used by the lender as long as the borrower doesn't file bankruptcy or do any "bad boy" act that has the effect of stealing from the property. And in my 2009 MLI outline I included the following sentence indicating my opinion that the assurance was more likely than not accurate:

> "In fact, it is likely that in most situations the verbal assurances of the lender's loan officer will be honored by the lender." Wallenstein, 2009.

B. Recent Lender Actions Raising Questions about Those Assurances. Reminding readers of my apology in *footnote 1* on page 1 of this outline, it is now my opinion that a few of the court decisions that are described in this section of the outline, and especially the lenders' actions in instituting the litigation in the first place, indicate that my 2009 MLI comment, quoted immediately above, is no longer a reliable prediction as to at least a portion of the mortgage lender community:

(1) Michigan. In the December 27, 2011 Michigan state court decision, Wells Fargo Bank, NA vs. Cherryland Mall Limited Partnership, 295 Mich. App. 99, 812 N.W.2d 799 (Mich. Ct. App. Dec. 27, 2011), which is accessible at http://caselaw.findlaw.com/mi-court-of-appeals/1589940.html, and in the December 12, 2011 decision of the United States District Court for the Eastern District of Michigan in 51382 Gratiot Avenue Holdings, LLC v. Chesterfield Development Company, LLC, 2011 WL 6153023, 2001 U.S. Dist. LEXIS 142404 (E.D. Mich., Dec. 12, 2011), which is accessible at http://law.justia.com/cases/federal/district-courts/michigan/miedce/2:2011cv12047/258665/90, each court held that the borrower's failure to have sufficient funds in its bank account to pay the mortgage constituted insolvency, which in turn triggered the springing full recourse provision requiring the borrower to stay solvent (as one of the SPE requirements in the "Separateness Covenants" section of the loan documents), which in turn caused the loan to convert from non-recourse to full recourse. In effect, and I am not being facetious, each lender argued to the court, and each court held, that in those cases the non-recourse exculpation in the loan documents applied only as long as the borrower paid the loan -- what I have will refer to occasionally in this outline as an **"SPE Catch 22" [NOTE:** *For those you who are not familiar with the term "Catch 22" made popular in Joseph Heller's 1961 book of that name, you can check out the meaning of the term in most current dictionaries, as well as at through the following Wikipedia web link:* http://en.wikipedia.org/wiki/Catch-22_(logic).)], *where (i) the non-recourse provisions assure the borrower against a deficiency claim, subject only to carve-out liability,* ***but*** *(ii) the borrower is liable under the carve-out if the borrower does not "maintain adequate capital"* ***to pay the loan****.*

(a) Observation on a Common Law Rule of Contract Interpretation Relevant to the Two Michigan Cases. Much of the nationwide fervor regarding the Cherryland Mall and 51382 Gratiot Avenue opinions focuses on the effect that the opinions will likely have on the mortgage loan industry, especially the CMBS portion of that industry. And clearly this fervor is warranted. But I believe the fervor has perhaps overshadowed an equally important aspect of these decisions, i.e., the failure of each court to follow a long-standing common law rule of contract interpretation. In each of the two Michigan opinions, the court acknowledged that the non-recourse feature of the loan was an "essential" (that word is in each court's opinion) aspect of the loan transaction for the borrower. However, each court then appeared to disregard the rule of contract interpretation that to the maximum extent possible, each provision in a contract -- *a fortiori* an "essential" element of the contract -- is to be given effect in interpreting the contract. See, for example, *Restatement of Contracts (Second)*, §203 (1981), at pages 92-93: "In the interpretation of a promise or agreement or a term thereof, the following standards of preference are generally applicable [NOTE: *Four standards are stated, with the following being the* first *of the four listed.*]: (a) an interpretation which gives a reasonable, lawful, and effective meaning to all the terms is preferred to an to an interpretation which leaves a part unreasonable, unlawful, or of no effect; . . ." [NOTE: The 2012 supplement to this *Restatement* section includes more than 16 pages of case summaries for the four standards of interpretation, including the recent opinion in Kovach v. Zurich American Ins. Co., 587 F.3d 323, 336 (6th Cir. 2009), which quotes favorably and follows the above-quoted standard (a).]. See also *Williston on Contracts* §32:5 (4th Edition 1999), at page 427: "An interpretation which gives effect to all provisions of the contract is preferred to one which renders a portion of the writing superfluous, useless or inexplicable." [NOTE: The 4th Edition cites more than 40 cases in a footnote to that statement, and the 2006 supplement includes six pages of additional case summaries for that statement and similar statements, and the statement has been quoted favorably and followed at least as recently as Priority Healthcare v. Aetna Specialty Pharmacy, 590 F.Supp.2d 663, 668 (U.S. Dist. Ct. Delaware 2008)]. And the standard espoused in the *Restatement* and in *Williston* is one that has regularly been espoused by the Supreme Court of Michigan: "[C]ontracts must be 'construed so as to give effect to every word or phrase as far as practicable.' [quoting from a 1940 Supreme Court of Michigan opinion, which in turn quoted from a 1938 Supreme Court of Michigan opinion] . . . courts must also give effect to every word, phrase, and clause in a contract and avoid an interpretation that would render any part of the contract surplusage or nugatory." Klapp v. United Insurance Group Agency, Inc., 468 Mich. 459, 467-68, 663 NW2d 447 (2003), which is accessible at http://caselaw.findlaw.com/mi-supreme-court/1357459.html and was cited favorably this year for the same principle applied to statutory construction in Sietsema Farms Feeds, L.L.C. v. Department of Treasury, Michigan Court of Appeals Case No. 302022, Tax Tribunal LC No. 00-355649, unpublished opinion approved for publication April 17, 2012. To be sure, law treatises provide several standards for contract interpretation, some of which may in conflict with others, depending on the language in the applicable contract. But when a court acknowledges that a particular provision is an "essential" element of the contract, it would seem likely that the court would then seek to find a way to harmonize the language in the contract as stated in the standard that is quoted above. Specifically with regard to the effect of solvency requirements on a non-recourse loan, it would seem that a court could very logically interpret -- should interpret -- the solvency requirements in the same manner as the parties to loans have understood them prior to the Michigan litigation, i.e., that the solvency requirements are not intended to cause an "SPE Catch 22" but instead are intended to prevent a borrower from depleting its cash flow voluntarily, claim insolvency as the result of such depletion, and then also claim that its entity should be consolidated with another entity in bankruptcy proceedings.

(b) The Michigan Nonrecourse Mortgage Loan Act. In a rather rapid response to the two Michigan cases discussed above, the Michigan State

Legislature enacted and the Governor of Michigan signed on March 29, 2012, the Michigan Nonrecourse Mortgage Loan Act, accessible at: http://www.legislature.mi.gov/(S(jargcx55ryh350fgplwsioac))/mileg.aspx?page=getObject&objectName=2012-SB-0992. See also Levy, "Legislature passes 'one of the more disturbing bills' following insolvency decisions," *The Michigan Lawyer* (a blog from Michigan Lawyers Weekly), April 2, 2012, accessible at: http://michiganlawyerblog.wordpress.com/tag/51382-gratiot-ave-holdings-llc-v-chesterfield-development-co-llc. This legislation, and the speed with which it was enacted, demonstrates the fears expressed within the mortgage lending industry for the damaging effect of those two cases -- on lenders as well as borrowers [See, for example, Forte, "Topsy-Turvy: The World of Commercial Real Estate Finance Turned Upside Down," 5 *Real Estate L. & Industry Rep.* (BNA) No. 181 (March 20, 2012), expressing lending industry concerns that the two Michigan cases will prompt more bankruptcies because a borrower/guarantor who faces liability under the solvency covenant will have "nothing to lose" by filing for bankruptcy protection.] It is likely that lenders will challenge the constitutionality of the Michigan Nonrecourse Mortgage Loan Act, especially the retroactive aspect of the Act. However, constitutional issues aside, I have a concern that the new Michigan statute is too limited in two respects. ***First***, its operative provision is limited solely to solvency covenants:

> "A post closing solvency covenant shall not be used, directly or indirectly, as a nonrecourse carveout or as the basis for any claim or action against a borrower or any guarantor or other surety on a nonrecourse loan."

Accordingly, there is no limitation on other "gotcha" recourse carve-out provisions that may work there way into mortgage loan documents; in fact, by the Act's specific singling out of only the solvency covenants, other "gotcha" clauses may be deemed to have been deemed acceptable if a court follows the principle of *expressio unius est exclusio alterius*. ***Second***, and even more important to parties located outside the State of Michigan, if the Michigan statute causes the higher state and federal courts in Michigan to refrain from overturning the two above-cited decisions, then those decisions may be cited as authority by other courts around the country. In fact, it is possible that the legislation, without subsequent overturning of the court decisions, might tempt courts outside Michigan to give even more weight to the court decisions than they otherwise would have done. As I indicated above, I believe the two Michigan court opinions are incorrect in that the courts failed to comply with relevant rules of contract interpretation, including that courts should attempt to give effect to all parts of the contract (in this instance, the part that each Michigan court expressly acknowledged to have been an "essential" element of the transaction). And I am concerned that the Michigan statute may be interpreted in states other than Michigan as demonstrating the correctness of the Michigan court decisions as to contract common law, with other courts saying something like "the Michigan decisions must be good contract-interpretation common law since it took a legislative act to change their holdings."

(c) Michigan Case Update. According to information that has been available to the author as of the date of preparation of this outline, the 51382 Gratiot Avenue litigation has been settled and therefore no appeal is pending. Similarly, another case instituted in Michigan on the heels of Cherryland Mall and 51382 Gratiot Avenue in which the lender lender's claim mirrored the claims in those two cases, 5417 Bay Road Holdings, LLC v. Landmark Plaza Associates Limited Partnership, Eastern District of Michigan, Northern Division, Case No. 1:11-cv-12347-TLL-CED (2011), appears to have been settled. With regard to the Cherryland Mall litigation, the December 27, 2011 opinion of the Michigan Court of Appeals in that litigation was appealed to the Michigan Supreme Court; however, by order dated September 29, 2012, the Michigan Supreme Court remanded the case to the Michigan Court of Appeals for a ruling as to the retroactive nature (and accordingly, applicability to the litigation) of the Michigan Nonrecourse Mortgage Loan Act. In its brief one-paragraph order, the Supreme Court also stated: "In all other respects, leave to appeal is DENIED, because we are not persuaded that the remaining questions should now be reviewed by this Court." 820 N.W.2d 901 (2012) http://scholar.google.com/scholar_case?case=14126357661247448628&q=Wells+Fargo+Bank,+NA+v.+Cherryland+Mall+Limited+Partnership&hl=en&as_sdt=2,44&as_vis=1. As of the date of completion of this outline, I have not received information as to the status of the litigation after remand.

(d) Commentary on What the Three Michigan Cases Sadly Demonstrate: The Willingness of Some Lenders to Seek an "SPE Catch 22: Result. Above in this subsection B.(1), I used the term "SPE Catch 22," analogizing the possibility of liability under SPE provisions in non-recourse mortgage documents to the "Catch 22" described in Joseph Heller's 1961 book of that name, referring to the "catch" that renders meaningless the very purpose of the rule. When I first used that term in my 2009 MLI outline, I never anticipated that it would actually be argued by a lender with a straight face. Now we have evidence that at least three lenders have made an "SPE Catch 22" argument.

(2) Texas. While not as dramatic as the two Michigan cases summarized above, the following appellate decision from Texas also has foreboding overtones of a guarantor's becoming liable for the entire loan amount even though the borrower had not committed what most would consider a "bad boy" act. In March 20, 2011, the Fort Worth Court of Appeals in Texas published an opinion in Pineridge Associates, L.P. vs. Ridgepine, LLC, 337 S.W.3d 461 (Tex. App. - Fort Worth 2011, *no writ history*), which is accessible through the following web link: http://www.law.com/jsp/tal/PubArticleTAL.jsp?id=1202487047108&slreturn=1. In its decision, the court upheld a finding of springing full recourse for the borrower's having violated the covenant requiring the borrower to cause any mechanics lien claims to be released by public record. The lender brought its claim against the borrower and the guarantor after it had foreclosed on the mortgaged property; and all parties agreed, and the court acknowledged, that the foreclosure had wiped out the mechanics lien claims. So all parties had agreed, and the court acknowledged, that the lender's title after foreclosure was not in any way encumbered by the mechanics lien claims, i.e., the lender suffered no harm from the pre-foreclosure mechanics lien claims. Nevertheless, the court held that extinguishing the liens by foreclosure was not the same as the borrower's causing them to be released of record and, accordingly, the borrower had violated the springing full recourse provision and the borrower and guarantor were liable for the full loan deficiency. The court did not consider the question of whether springing from non-recourse to full recourse on account of an act that caused no damage to the lender might have constituted an unenforceable penalty.

In another recent Texas case, Wells Fargo Bank, N.A., Trustee vs. HB Regal Park, LLC et al, Case No. 05-10-01428-CV, Court of Appeals of Texas, Fifth District, Dallas, August 29, 2012, accessible through the following web link: http://caselaw.findlaw.com/tx-court-of-appeals/1611423.html, the mortgage lender argued (1) that an improper repayment of so-called "loans" to entities affiliated with the borrower violated the single purpose entity requirements in the loan documents and therefore caused the otherwise non-recourse loan to become a full recourse loan and (2) even if the borrower was not liable for the full amount of the loan, the borrower was liable for waste. The Dallas Court of Appeals rejected the springing full recourse argument of the lender but did find the borrower and its guarantor liable for waste.

(3) California. In March 2012, a California appellate court issued its decision in GECCMC 2005-C1 Plummer Street Office Limited Partnership v. NRFC NNN Holdings, LLC, 2012 Westlaw 1035318 (Cal. App., filed March 29, 2012), which is accessible at http://caselaw.findlaw.com/summary/opinion/ca-court-of-appeal/2012/03/29/258582.html , where the lender had sought springing full recourse liability against a mortgage loan guarantor under a provision in the loan documents that triggered springing full recourse if "without the prior written consent of [the lender, either lease] is terminated or canceled." The two mortgage properties had been leased to a single tenant, Washington Mutual Savings and Loan; and when Washington Mutual had gone out of business and its successors had ceased paying rent and abandoned the properties, the borrower had defaulted. The lender initiated litigation against the guarantor, seeking $42 million under the above-quoted provision. The trial court entered summary judgment for the lender; however, the appellate court reversed the trial court's judgment, holding that the tenant's default did not "terminate" the lease because the borrower (i.e., the landlord) never gave notice of termination to the tenant. While much of the appellate court's opinion is based upon its interpretations of various provisions in the California Civil Code, the appellate court did include in its opinion an acknowledgment of the purpose of so-called "bad boy" carve-out provisions in non-recourse loan documents and the court's preference not to characterize a tenant's unilateral abandonment of the property as a "bad boy" act of the borrower. In addition, the California appellate court also reported the lender's attempt to rely on the above-described Cherryland Mall Michigan state court decision; and while distinguishing the facts of the Michigan case from those in the California case, the California appellate court also raised a question as to whether California courts would follow the Michigan court's reasoning, saying: "even assuming that we would follow the *Cherryland* opinion ..."

(4) **Illinois.** On December 28, 2012, an Illinois appellate court issued its decision in Bank of America, N.A. v. Laurance H. Freed, Cause No. 09 CH 39930, 2012 Il. App (1st) 110749, which is accessible at http://www.state.il.us/court/Opinions/AppellateCourt/2012/1stDistrict/1110749.pdf. In that decision the court upheld a finding by the lower court of springing full recourse against a guarantor, resulting from the borrower's having violated a springing full recourse restriction not to "contest, delay or otherwise hinder any action taken by the Agent or the Lenders in connection with the appointment of a receiver for the Premises . . ." To be sure, the borrower's voluntary action in appealing the trial court's appointment of a receiver was a clear violation of the springing full recourse restriction; moreover, an opinion issued by the same court earlier in the year, with the same parties on a related matter, Bank of America, N.A. v. Laurance H. Freed, 2012 IL App (1st) 113178, March 27, 2012, accessible at http://www.state.il.us/court/opinions/AppellateCourt/2012/1stDistrict/1113178.pdf, may have contributed to the appellate court's denying in its December decision the guarantor's defense founded in equity. In addition, the holding in this case is consistent with the 2009 decision by a New Jersey appellate court in CSFB 2001-CP-4 Princeton Park Corporate Center, LLC v. SB Rental I, LLC, 410 N.J. Super. 114, 980 A.2d 1 (App. Div. August 11, 2009), which decision is accessible at http://caselaw.findlaw.com/nj-superior-court-appellate-division/1444523.html and is discussed at pages 24-25 and at page 29-30 of this outline (this cross reference is to portions of my June 2011 *e*Report paper entitled *An Updated Report and Analysis on Springing Recourse Guaranties in Mortgage Loan Transactions*, which is attached as an Appendix to this outline). However, the development which I deem noteworthy and unfortunate with regard to this decision is the manner by which the Illinois appellate court rejected the guarantor's defense based upon the springing full recourse provision being a "penalty." In its opinion denying the "penalty" defense, the Illinois court adopted and quoted the following language from the New Jersey appellate court's opinion in the SB Rental case cited above:

> "The carve-out clause is not a liquidated damages provision for yet another reason: it provides for only actual damages. Unlike the typical stipulated damages provision which reasonably estimates an amount otherwise difficult to compute, the carveout clause permits the lender to recover only damages actually sustained, namely the amount remaining on the loan at the time of breach. Such an amount is fixed by the terms of the loan and is therefore neither speculative nor incalculable."

As I pointed out in my June 2011 *e*Report paper that is attached as an Addendum to this outline (see pages 29-30 of this outline), I believe the above-quoted rationale, now espoused by two appellate courts, is erroneous because it mistakenly confuses the effect on the lender resulting from the borrower's failure to repay the loan (which is not a recourse event -- to the contrary, it is the very basis for the non-recourse exculpatory language) with the damages caused to the lender by the borrower's taking an action that is proscribed in the springing recourse provision. And the facts in both the 2009 SB Rental litigation and the 2012 Laurance H. Freed litigation are excellent examples of the author's thesis. The springing full recourse action that had been taken by the borrower in the SB Rental litigation had been the borrower's consummating a second-lien loan; however, that second-lien loan had been paid off in full more than a year before the first-lien loan went into default, so the first-lien lender obtained a judgment against the guarantors for the outstanding balance of a $13,300,000 loan amount although the lender unarguably had suffered no damage whatsoever from the violation. And as mentioned above, the springing full recourse action that had been taken by the borrower in the Laurance H. Freed litigation had been the borrower's appeal of a receiver order obtained by the lender; however, the facts recited by the court indicate that the appeal was dismissed within approximately a month, and it is unlikely that such a short delay caused damages to the lender of a degree justifying the award of $94 million in damages. Unfortunately, the Illinois court, by following and quoting the statement of the New Jersey court that springing full recourse "provides only for actual damages" (as quoted above and then disputed by the author above), may have added to the stare decisis value of the New Jersey court's rationale in its SB Rental decision. In this regard, the author is reminded of the often-quoted dissenting opinion by Colorado Supreme Court Justice Tully Scott in the 1916 opinion of the Colorado Supreme Court in Van Kleeck v. Ramer, 63.156 P. 1108, 1121 (Colo. 1916), where in pointed out the often illogical effect of stare decisis, Justice Scott quoted from the poem "The Calf-Path" http://www.poets.org/viewmedia.php/prmMID/21413, where a young calf wanders home in "a crooked trail as all calves do" and then other animals, then people, then roads blindly followed the same crooked trail until it became the main thoroughfare of the city. For how that poem and Justice Scott's opinion has been used. see for example http://www.duhaime.org/LawFun/LawArticle-411/The-Stare-Decisis-Calf-Path.aspx.[3]

3 The one bright spot in the opinion of the Illinois court in Laurance H. Freed was the court's not-totally-unfavorable citing of ING Real Estate Finance (USA) LLC v. Park Avenue Hotel Acquisition LLC, 907 N.Y.S. 437 (N.Y. Sup. Ct. 2010) (discussed the Appendix to this outlined on pages 26-27), where the New York court had found applicable the concept of "penalty" in a section of its opinion introduced by the following statement of the New York court: "The question before the Court is whether, by the terms of the contract, the nineteen-day tardiness in paying less than $300,000 in property taxes triggers a full recourse obligation by the Guarantors of up to $90 million." The Illinois court in the Laurance H. Freed litigation failed to find the Park Avenue Hotel Acquisition analysis to be controlling; however, the Park Avenue Hotel Acquisition analysis was distinguished by its facts instead of being rejected altogether, thus indicating possibly a different outcome if the springing full recourse violation in the Laurance H. Freed litigation had not been so willful.

3. NEGOTIATING THE SPECIFIC PROVISIONS OF NON-RECOURSE LOANS

3.1. Forms of Non-Recourse Exculpatory Provisions.

3.1.1. Provision that grants a non-recourse exculpation:

Notwithstanding any provision to the contrary in this Note or the Loan Documents and except as otherwise provided for in the following paragraph of this Note [*COMMENT: What is referred to immediately above as the "following paragraph" contains the carve-out provisions, which will be discussed below in this outline*.], the liability of Borrower under the Loan Documents shall be limited to the interest of Borrower in the Mortgaged Property. In the event of foreclosure of the liens evidenced by the Loan Documents, no judgment for any deficiency upon the Indebtedness evidenced by the Loan Documents shall be sought or obtained by Lender against Borrower. Nothing herein shall in any manner limit or impair (i) the lien and the lien enforcement pursuant to the Loan Documents, or (ii) the obligations of any indemnitor or guarantor, if any.

3.1.2. Another provision, with a non-recourse exculpation but then raising questions with the "boilerplate" [see the ***bold italicized portion*** of item (vii) below]:

Notwithstanding any provision to the contrary in this Note or the Loan Documents and except as otherwise provided for in the following paragraph of this Note, Lender shall not be entitled to recover any deficiency judgment against Borrower or any general partner (if any) of Borrower on this Note, provided, however, the foregoing shall not be interpreted to waive or otherwise adversely affect: (i) any Lien created by any of the Security Documents or other Loan Documents, (ii) any indemnity, guaranty or similar agreement now or hereafter made in connection with the Loan, (iii) Lender's right to have a receiver appointed for the Project, (iv) Lender's right to name Borrower as a defendant in any foreclosure action or other action or proceeding affecting or involving any of the Collateral or in any action or proceeding for specific performance, (v) Lender's right to obtain insurance proceeds or condemnation awards to which Lender would otherwise be entitled, except that any such judgment against Borrower shall, except as otherwise provided in this Article 8, be enforceable against Borrower only to the extent of Borrower's interest in the Project and all other Collateral, (vi) any right of Lender under the Federal Bankruptcy Code to file a claim in the full amount of the Loan or to require that the Collateral continues to secure all of the indebtedness owing to Lender under the Loan Documents, or (vii) any other right of Lender ***to enforce its remedies under the Loan Documents.***

3.1.3 Problem with the Second Version.

Generally the "remedies under the Loan Documents" (quoting from the ***bold italicized portion*** of item (vii) at the conclusion of the above paragraph) include the right to sue the borrower for a deficiency, with all parties intending that such right is being over-ridden by the non-recourse language elsewhere in the loan documents. But if notwithstanding the non-recourse provision, the lender nevertheless is entitled to exercise "any other right . . . to enforce its remedies under the Loan Documents," could that be argued by a lender to mean that the non-recourse provision is rendered totally meaningless by its exception? Until the Cherryland Mall and 51382 Gratiot Avenue cases that I have summarized in Section 2.2.2 above, I would have deemed such a possibility to be absurd, and I would regularly accept the label of "nitpicking" when I sought to clarify that provision (as I often have done, but as an admitted "nitpick" point and not a "deal killing issue"). I still believe that no court could logically find the non-course provision to be rendered totally meaningless by its exception; however, after the lenders' arguments in the cases discussed in Section 2.2.2 above in this outline, I no longer believe unthinkable the possibility that a lender might try to argue it. As for legal justification for the ***bold italicized portion*** quoted above, an occasional rationale used by lenders is that a debt must exist for a lien to be enforceable. But analysis such as in the following court decision demonstrates that the lenders' rationale is invalid: Bedian v. Cohn, 134 N.E. 2d 532 (Ill. 1956), which is accessible through the following web site: http://www.leagle.com/xmlResult.aspx?xmldoc=195612610IllApp2d116_1111.xml&docbase=CSLWAR1-1950-1985, holding that it is not essential to the validity of a mortgage that there be a personal-liability promise by the mortgagor to pay, i.e., the debt exists despite the absence of personal liability. The Bedian opinion was cited favorably in *Friedman on Contracts* (Release #7, May 2009), page 3-138 (footnote 663 in §3:8.2). See also City of Joliet v. Alexander, 62 N.E. 861, 863 (Ill. 1902), and Shelley v. Byers, 238 P. 177 (Cal. App. 1925) (personal liability for the repayment of a debt is not a requisite of a valid mortgage).

3.2. Carve-Outs from Non-Recourse Exculpation.

3.2.1. A Sampling of Carve-Out Provisions

Generally, after a paragraph such as described in Section 3.1 above, the applicable loan document will include a so-called "carve-out" paragraph containing one of more of the following aggregate of provisions that I have seen over the years (from various loan documents and CLE materials, ***not*** from a single loan transaction):

Notwithstanding any provision hereinabove to the contrary, Borrower [or Guarantor] shall be personally liable to Lender for any loss or damage sustained by Lender resulting from:

(a) Borrower's failure to pay any of the taxes, assessments or similar charges specified in the Mortgage;

(b) Borrower's failure to apply condemnation proceeds as prescribed in the Deed of Trust;

(c) the failure of Borrower's insurance to pay all costs of restoration after a casualty;

(d) the failure of Borrower to maintain the Property in first-class condition;

(e) any event or circumstance for which Borrower indemnifies Lender under the Environmental Indemnity;

(f) any Rents (as defined in the Loan Documents) that Borrower receives after it defaults in any of its obligations under the Loan Documents, except to the extent that such Rents are applied either to (i) the payment of principal, interest and other charges due under the Loan Documents or (ii) the payment of ordinary and necessary operating expenses of the Property;

(g) any security deposits or other refundable deposits or prepaid rents not turned over to Lender upon conveyance of the Property to Lender pursuant to foreclosure or power of sale or by a deed acceptable to Lender;

(h) any sums expended by Lender in fulfilling the obligations of Borrower as lessor under any Lease of the Property prior to a foreclosure sale or a conveyance of the Property to Lender by deed in lieu of foreclosure, or expended by Lender after either of such events for obligations of Borrower which arose prior to that event;

(i) any loss or damage to Lender arising from any fraud or willful misrepresentation by or on behalf of Borrower;

(j) the failure of Borrower to comply with the single-purpose entity requirements listed in Section _____ of the Deed of Trust; and

(k) the failure of Borrower to comply with its obligations in connection with Lender's sale of this Loan.

3.2.2. Set out below is a "redlined" version of the same "carve-out" provision showing changes recommended by the Borrower:

Notwithstanding any provision hereinabove to the contrary, Borrower [or Guarantor] shall be personally liable to Lender for:

(a) Borrower's failure to pay any of the taxes, assessments or similar charges specified in the Mortgage **[1]** **attributable to the period of time that Borrower owns the Property**; **[2]** **provided, however, that this subsection (a) shall not apply if and to the extent that Lender holds escrow funds for the payment of such taxes, assessments and/or similar charges**; **[3]** **provided, further, that Borrower's liability under this subsection shall be limited to net operating revenues actually received by Borrower from the Property that are not used to pay such taxes, assessments and/or similar charges;**

(b) Borrower's failure to apply condemnation proceeds as prescribed in the Deed of Trust;

(c) the failure of **Borrower to use available insurance proceeds** from Borrower's insurance to pay all costs of restoration after a casualty;

(d) ~~the failure of Borrower to maintain the Property in first-class condition~~; **the Borrower's willful physical waste of the Property; provided, however, Borrower shall have no liability under this subsection (d) if sufficient net operating revenues are not available to Borrower from the Property to prevent such material physical waste**; [**NOTE 1:** *While I prefer the word "willful" in this provision and also suggest adding the proviso as to sufficient revenues, I have not generally made that category of clarification a "deal point" issue in this provision,*

since definitions of "waste" rather clearly do not include ordinary wear and tear, and most definitions found in appellate opinions include a requirement that the wasting party act or fail to act willfully, or at least irresponsibly. However, I believe borrowers should consider at least adding the proviso for "sufficient revenues," especially in light of a report I received from an attorney several years ago about a scenario where a borrower owning a vacant building told the lender that it was "giving back the keys"; however, the lender refused to take foreclosure action or accept a deed in lieu of foreclosure and instead demanded that the borrower/guarantor use its own funds to keep the property free from waste until the lender decided what it wanted to do with the property.] [**NOTE 2:** *For a court analysis as to why a Borrower should strive to limit this provision to "**physical**" waste, see U.S. Bank, National Association, as Trustee, and Orix Capital Markets, L.L.C., v. American Realty Trust, Inc., 275 S.W.3d 647 (Tex. App. - Dallas 2009, pet. denied), which is accessible through the following web link:*
http://law.justia.com/cases/texas/fifth-court-of-appeals/2009/05-07-00328-cv-5.html, *with a further procedural development on this litigation (with no discussion regarding the issue of "physical waste") being reported at Orix Capital Markets, LLC v. American Realty Trust, Inc., Case No. 05-10-01005-CV (Tex. App. - Dallas, December 14, 2011), where the lender claimed the recourse carve-out provision for "waste" was triggered by the borrower's changing the "flag" of the hotel from a Holiday Inn to a Clarion Hotel. The court determined that the specific facts of the case showed the flag change not to have constituted "waste" in this instance; however, in its opinion, the court acknowledged that the term "waste" was not necessarily limited to physical waste and that if the specific facts had so warranted in the case, the flag change might have constituted "waste". See also Travelers Insurance Company v. 633 Third Associates, Tower 41 Associates, et al, 14 F. 3rd 114 (2nd Cir. 1994), where the court held that the borrower's willful failure to pay real estate taxes constituted actionable waste, thereby triggering recourse carve-out liability.*]

(e) any event or circumstance for which Borrower indemnifies Lender under the Environmental Indemnity [**NOTE 1:** *In connection with this carve-out, borrowers and guarantors should review the Environmental Indemnity for post-foreclosure liability and should attempt to exclude from post-foreclosure liability any environmental problems that occur for the first time after foreclosure*.] [**ASIDE:** *Often carve-outs are referred to as "bad-boy" provisions; however, borrower/guarantor liability for environmental problems generally does not fit within any logical definition of "bad-boy" since the liability is not limited to wrongful borrower acts. Does that make logical sense? In this instance, the principal explanation is that lenders have historically required environmental carve-outs and "a page of history is worth a volume of logic." Justice Oliver Wendell Holmes, Jr. in New York Trust Co. v. Eisner, 256 U.S. 345, 349 (1921).*] [**NOTE 2**: *Many Borrowers are now substituting environmental insurance for environmental liability to the Borrower/Guarantor*.] ;

(f) any Rents (as defined in the Loan Documents) that Borrower receives after ~~it defaults in any of its obligations~~ **an uncured Event of Default** under the Loan

Documents, except to the extent that such Rents are applied either to (i) the payment of principal, interest and other charges due under the Loan Documents or (ii) the payment of ~~ordinary and necessary~~ **bona fide** operating expenses of the Property [**NOTE:** *I admit that I have a fetish for the word "**uncured**" or a concept to that effect, so that a fictional "workout artiste" (see Section 2.2.1 above) or a real-life lender (see Section 2.2.2 above) does not have any rationale to claim that a default which occurred and was cured early in the loan history might give cause for the carve-out mentioned in this paragraph to be applicable long after the initial default had been cured. And see the case of CSFB 2001-CP-4 Princeton Park Corporate Center, LLC v. SB Rental I, LLC, 410 N.J. Super. 114, 980 A.2d 1 (App. Div. August 11, 2009), which is described in my e-Report article attached as an Appendix to this outline, where the lender sued for springing full recourse despite the fact that the borrower's "bad boy" act of placing a subordinate lien on the property had been totally cured by the borrower's paying off the subordinate loan and releasing the subordinate lien well before the borrower defaulted under its first-lien mortgage.*];

(g) any security deposits or other refundable deposits or prepaid rents not turned over to Lender upon conveyance of the Property to Lender pursuant to foreclosure or power of sale or by a deed acceptable to Lender;

(h) any sums expended by Lender in fulfilling the obligations of Borrower as lessor under any Lease of the Property, **provided that Borrower's liability for any such obligation was specific in nature (e.g., a specifically identified broken piece of equipment and not merely "to keep the premises in good condition") and was either acknowledged by Borrower or definitively identified in writing by the tenant** prior to a foreclosure sale or a conveyance of the Property to Lender by deed in lieu of foreclosure, or expended by Lender after either of such events for obligations of Borrower which arose prior to that event;

(i) any fraud or willful misrepresentation by or on behalf of Borrower;

(j) the failure of Borrower to comply with the single-purpose entity requirements listed in Section _____ of the Deed of Trust; **[one alternative] provided, however, that this item (j) shall not be applicable to item ___ in Section ______ of the Deed of Trust (which requires Borrower to "maintain adequate capital in light of its contemplated business operations") [another alternative] provided however, that such failure shall be grounds for liability only if such failure results in the substantive consolidation of the assets and liabilities of Borrower with those of another party pursuant to the Bankruptcy Code in either a voluntary bankruptcy proceeding instituted by Borrower or an involuntary bankruptcy proceeding instituted by creditors of Borrower** [*NOTE: In connection with this carve-out, borrowers and guarantors should review the single-purpose entity requirements carefully and remove -- at least from carve-out liability -- any obligation to the effect that the borrower "maintain adequate capital in light of its contemplated business operations." While the purpose of that particular SPE requirement is generally considered to be limited to daily operations for which the borrower has sufficient cash flow -- i.e., a covenant by the borrower not to deplete* *its cash flow voluntarily, claim insolvency as the result of such depletion, and then also claim that its entity should be consolidated with another entity in bankruptcy proceedings -- a literal interpretation of that SPE requirement could lead to what I have described in Section 2.2.2.B.(1) above as an "SPE Catch 22"*; and

(k) the failure of Borrower to comply with its obligations in connection with Lender's sale of this Loan [*NOTE: In connection with this carve-out, borrowers and guarantors should review the Lender-sale provisions of the Deed of Trust carefully and should remove any obligation of the borrower to engage auditors or other consultants and/or to certify to materials, descriptions, projections, etc. that are prepared by the lender or its mortgage banker*.].

3.3. "Springing Recourse" (Sometimes Called "Springing Full Recourse").

3.3.1. A Sampling of "Springing Full Recourse" Provisions.

Frequently, the applicable loan document will follow the "carve-out" provision such as shown in Section 3.2 above with a so-called "springing full recourse**"** provision, containing one or more provisions such as the following aggregate of provisions that I have seen over the years (from various loan documents and CLE materials, ***not*** from a single loan transaction):

Notwithstanding anything to the contrary in the Loan Documents, the limitation on liability contained in the first paragraph of this section shall become null and void and shall be of no further force and effect, i.e., this Loan shall bear full recourse to Borrower [and/or the Guarantor(s)], if any one or more of the following events occur:

(1) Borrower's filing for voluntary bankruptcy, insolvency, receivership or similar proceeding;

(2) An involuntary bankruptcy, insolvency or receivership proceeding being filed against Borrower and Borrower's failure to cause such action to be dismissed within sixty (60) days of filing;

(3) Borrower's making an assignment for the benefit of creditors, or admitting, in writing or in any legal proceeding, its insolvency or inability to pay its debts as they become due [ALERT: This provision contains your speaker's candidate for the next potential "Catch 22" for non-recourse loans.];

(4) Opposition by Borrower to Lender's exercise of its rights under the Loan Documents, including without limitation foreclosure on the Property;

(5) Any Transfer other than a Permitted Transfer;

(6) Borrower's commission of any fraud or intentional misrepresentation;

(7) Borrower's failure to deliver the first payment under the Note when due;

(8) Borrower's failure to comply with provisions in the Deed of Trust regarding Borrower's status as a single purpose entity;

(9) Borrower's failure to deliver financial reports as required by the Deed of Trust;

(10) Borrower's failure to permit inspections of the Property; or

(11) Lender's preferring money instead of getting back the Property

NOTE TO THIS MARCH 2013 DALLAS BAR PROGRAM: Item (11) above was included as Item (10) in my 2009 MLI outline as a joke. In fact, I followed it with the bracketed comment:

> *COMMENT BY YOUR MLI SPEAKER: Item (10) is a joke -- I'm just checking to see if you are reading carefully*!

After the arguments made by the lenders in the Cherryland Mall litigation and the 51382 Gratiot Avenue litigation, both being summarized in Section 2.2.2 above, that 2009 comment seems more ominous than humorous.

3.3.2. Possible Borrower/Guarantor Responses to the Various "Springing Full Recourse" Provisions.

3.3.2.1. Voluntary Bankruptcy. I seldom recommend to clients that they oppose springing full recourse for the borrower's ***voluntary*** bankruptcy, insolvency, receivership or similar proceeding. If there is a stated or implied "deal" between the lender and the borrower (and in Section 6 of my *e*-Report article attached as an Appendix to this outline, I question whether the parties actually do state or even conceptualize any "deal" at all), that "deal" is likely that the lender will not pursue any deficiency in return for the borrower's not using the bankruptcy tactic to delay the lender's foreclosure. However, a guarantor who does not totally control the actions of the borrower should consider the possibility of the borrower's instituting a voluntary bankruptcy, etc. action as the result of the action of another partner of the borrower and without the guarantor's permission. [*NOTE: Even if the partner's action in causing the borrower to file for bankruptcy is a "rogue" action that is proscribed by the partnership agreement, it may nevertheless give the lender a reason to argue that the guarantor is liable for springing full recourse. In fact, the appellate court's opinion in 111 Debt Acquisition LLC v. Six Ventures, Ltd. et al., 413 F. App'x 824 (6th Cir. 2011), which is analyzed in my e-Report article attached as an Appendix to this outline, contains a statement by the Court that liability is to be imposed upon an objecting guarantor despite the fact that the internal governance documents of the borrower relating to the authority to file a bankruptcy did not alter the terms of the loan documents: "Under the plain language of the loan documents, therefore, the debt is fully recourse regardless of whether the other guarantors – the defendants – contested the bankruptcy filing*."] A guarantor whose status is subject to that possibility should consider negotiating for a removal from guarantor springing full recourse if such guarantor actively opposes the action and cooperates with the lender in seeking a discharge.

3.3.2.2. Involuntary Bankruptcy. Lenders commonly fail to include, or at the borrower's request will remove, ***involuntary*** bankruptcy from the list of springing full recourse events. If not, the borrower should seek to limit springing full recourse either (1) to an involuntary bankruptcy resulting from the borrower's conspiring with the filing creditors, or (2) which the borrower fails to oppose. The above provision, where springing full recourse occurs if the involuntary proceeding is not dismissed within 60 days, is unreasonable in that the borrower has no control of that event.

3.3.2.3. Admitting in Writing. The "admitting in writing" provision is your speaker's candidate for next attempt for lenders to seek, along the lines of lenders' actions in the Cherryland Mall and Gratiot cases, to convert a non-recourse loan to a full recourse loan solely due to the Borrower's failure of the Borrower to pay the debt. Read literally (in a manner comparable to what the lenders argued in the Cherryland Mall and Gratiot cases), those words would give an argument for springing full recourse if the Borrower writes a letter to the lender saying "I regret that we have lost some tenants, so we do not have funds to pay the loan and will have to let you foreclose," because the Borrower will have "admitted in writing" what the provision punishes with springing full recourse. And in fact, at least one lender has already attempted to use that provision for converting a non-recourse loan to full recourse. D.B. Zwirn Special Opportunities Fund, L.P. v. SCC Acquistions, Inc., 74 A.D 3d 530, 902 N.Y.S. 2d 93 (N.Y. - 1st Dept. 2010), which is accessible through the following web link: http://law.justia.com/cases/new-york/appellate-division-first-department/2010/2010-04923.html. The opinion in that case merits careful review not only because the Court (1) in *dicta* stated that an admission along the lines of what I have stated above would have triggered the springing full recourse provisions of the loan documents, but (2) then concluded that the borrower's merely sending of financial statements to the lender, without a statement of the borrower's inability to pay debts, did not satisfy the springing full recourse claimed by the lender. The following excerpt from the Court's opinion also indicates that the lender's attorney attempted to elicit such a liability-inducing statement from the borrower by what seems to this observer (an occasional viewer of TV police shows) to be entrapment:

> Although the affiliates' financial reports show they were experiencing financial difficulty, the statements contained in the reports were not written admissions as contemplated by section 1(b)(ii)(e) [NOTE: *That section of the applicable loan document imposed springing full liability on the guarantor if the borrower "admit[s], in writing, its insolvency or inability to pay its debts as they become due."*] because they did not contain the express statement required by the contract. Notably, two months after plaintiff received the reports, plaintiff's attorney twice sent correspondence to the attorney for the affiliates and defendant attempting to elicit written admissions of insolvency. Both the e-mail and the letter posed the same questions: "(i) [A]re the Southwind and Copper Canyon borrowers out of money, and (ii) will those borrowers make the loan payments that are past due and coming due this month?" It is abundantly clear that these questions were designed to extract written admissions from the affiliates. Thus, it is reasonable to conclude that plaintiff never believed that the financial reports it had already received contained the requisite written admissions, and that it needed further statements from the affiliates.

Alternative remedies for clarifying this recourse carve-out event might be (and the following possibilities are not mutually exclusive): (i) moving this prohibition "above the line" making the guarantor liable only for whatever damages might have been caused by the borrower's admission (and making clear that failing to pay the debt as the Borrower's "writing" acknowledges is not a cause for a damage claim); (ii) taking out the words "in writing"; (iii) excepting out an admission by the Borrower that it cannot pay the mortgage; and (iv) making clear that any such admission will result in liability only if the admission results in the substantive consolidation of the assets and liabilities of Borrower with those of another party pursuant to the Bankruptcy Code in either a voluntary bankruptcy proceeding instituted by Borrower or an involuntary bankruptcy proceeding instituted by creditors of Borrower.

3.3.2.4. Opposition by Borrower. I have seldom seen a provision proposed by any mortgage lender in any actual loan transaction that would impose "springing full recourse" for "opposition by Borrower to Lender's exercise of its rights under the Loan Documents, including without limitation foreclosure on the Property." However, provisions comparable to that concept have been included occasionally in speech outlines on the subject prepared by attorneys who represent lenders. In my opinion, if the borrower accepts any responsibility at all for opposing the lender's foreclosure action, it should be solely as a carve-out reimbursement for the lender's actual damages and not as "springing full recourse" for the entire loan amount. In addition, it is also helpful to add a qualification that no liability will be accessed if the borrower "prevails" or "is successful" in the litigation is helpful; however, that qualification should not be viewed as removing all concerns for the non-litigation carve-out provision, in light of the difficulty of defining "prevailing" or "successful" (a delay in the lender's action? a defense to repayment of the loan?). For example, see the recent 5-4 opinion by the Texas Supreme Court, with a vigorous 4-judge dissent, on the issue of "prevailing party." <u>Intercontinental Group Partnership v. KB Home Lone Star L.P.</u>, 295 S.W.3d 650 (Texas Supreme Court, August 28, 2009). See also <u>Lower Payette Ditch Co. v. Harvey</u>, Case No. 38163-2010 (Idaho Supreme Court January 5, 2012), where the Supreme Court affirmed the trial court's finding that neither party should be awarded attorneys fees in litigation by one landowner against its neighbors for damage to the plaintiff's land, because there was no "prevailing party" in the litigation. (Quoting from the trial court: "While [the plaintiff] did not obtain all the relief it requested, neither did the [the defendants].")

3.3.2.5. Transfers. Frequently, both restrictions on sale (so-called "due-on-sale" provisions) and restrictions on subordinate financing are linked together in the mortgage documentation by having the term "Transfer" include sales and mortgages. The borrower should try to limit, and I have often seen lenders willing to limit, the springing full recourse events to (i) a ***voluntary*** conveyance by deed of the property and (ii) a ***voluntary*** encumbrance of the property by deed of trust. I seldom recommend to clients that they oppose springing full recourse for those two instances of the borrower's acts, since both acts are exceptional and voluntary on the borrower's part (although the guarantors in <u>CSFB 2001-CP-4 Princeton Park Corporate Center, LLC v. SB Rental I, LLC</u>, 410 N.J. Super. 114, 980 A.2d 1 (App. Div. August 11, 2009), which is described in my *e*-Report article attached as an Appendix to this outline, may not agree with your speaker's cavalier approach to subordinate financing). The problem with parlaying springing full recourse with the term "Transfer" is that such term often includes one or more of the following:

	Action Often Included in "Transfer"	Suggestions for Requests by the Borrower
(i)	condemnation	Lenders generally are willing to exclude condemnation altogether.
(ii)	mechanics lien affidavit	Notwithstanding the <u>Pineridge Associates, L.P. vs. Ridgepine, LLC</u>, case that is summarized in Section 2.2.2 above, it has been my experience that lenders generally are willing to exclude mechanics lien affidavits from the term

		"Transfer." Even though a mechanics lien affidavit does technically encumber the title of the property (which often makes it a "Transfer" under the definition in the loan documents), it is not itself a lien. And since most mechanics lien affidavits expire and are not converted to liens by litigation within the statutory period, borrowers should resist requirements that lenders sometimes attempt to include in the loan documents that a lien affidavit be removed by a borrower's affirmative court action.
(iii)	leases	Lenders often resist excluding leases unless they have been approved in advance by the lender (often with some *de minimus* standard for small leases). Borrowers should try to move lease-related liability out of springing full recourse status and into carve-out liability status as described in Section 3.2 above.
(iv)	partnership transfers	Borrowers should try to limit this springing full recourse event to a transfer of either control or majority ownership. Often the initial provision drafted by the lender would cause a guarantor to be liable for the entire loan amount if an insignificant limited partner (e.g., a 1% limited partner with no effective voting rights) conveyed his or her interest to a family member.

3.3.2.6. Fraud. Lenders occasionally add "fraud" and/or "intentional misrepresentation" as a springing full recourse event, and they sometimes act astonished when the borrower requests that "fraud" and "intentional misrepresentation" be moved out of springing full recourse status and into carve-out liability status as described in Section 3.2 above. I have occasionally received comments such as the following: "Counselor [*ASIDE: Can you think of a time during a negotiation process when the term "Counselor" is* ***not*** *used in a pejorative sense*?], does your client really intend to commit fraud?" The problem with the terms "fraud" and "intentional misrepresentation" is that they are not, as some may assume, limited to an evil act of gargantuan proportions, with the borrower having been warned before committing the act because the theme music from the movie *Jaws* is playing the in background. Instead, the definition of "fraud" or "intentional misrepresentation" could include something as insignificant as the borrower's property manager, out of embarrassment instead of evil, fibbing about having fixed a small pothole in the parking lot as he or she had promised the lender's representative who had recently inspected the property. In addition, the question of whether "fraud" and/or "intentional misrepresentation" has occurred is often not readily determinable. For example, one of the most significant cases in the area of commercial real estate during the 1990's was the case of Prudential Insurance Company of America v. Jefferson Associates, 896 S.W.2d 156 (Tex. 1995), in which the lower courts uniformly held that a fraud had been committed, but the Texas Supreme Court ruled that no fraud had been committed.

In all but one instance in my experience, the lender has agreed to remove "fraud" and "intentional misrepresentation" from springing full recourse status and move that concept to carve-out liability status as described in Section 3.2 above. In that one exception, the springing full recourse provision was limited to fraud or intentional misrepresentation committed by the borrower in connection with the initial funding of the loan, and even then only if the fraud or intentional misrepresentation was likely to result in damages exceeding a considerable dollar amount (in your speaker's recollection, something in the range of $100,000). **SPECIAL ALERT:** The attempt to limit the liability of the borrower to actual damages suffered by the lender resulting from the borrower's alleged fraud or misrepresentation may not be totally successful if the court finds that the fraud or misrepresentation by the borrower was so grave that the loan would not have been made in the absence of the borrower fraud or misrepresentation. See <u>Diamond Point Plaza Limited Partnership v. Wells Fargo Bank, N.A.</u>, 929 A.2d 932 (Md. 2007), for a court decision finding the lender's loss to be the entire loan amount in a case where the borrower, according to the facts that the court found to be "undisputed," had known about but had failed to disclose to its mortgagee before the loan closing the planned departure of Sam's Club from the shopping center and had even signed loan closing documents representing that it had no knowledge of any tenant's intention to vacate.

3.3.2.7. Failure to Make the First Note Payment. The lender's rationale for this cause of springing full recourse is generally something like the following: "If you can't make the very first payment on time, what kind of borrower are you?" But viewed from the borrower's perspective, the very first payment may be the one where there is the greatest chance of being late, since the borrower's office will be in the process of setting up its payment procedures. I would prefer to have that first required payment be paid at the closing instead of worrying that the borrower's office might err in setting up its payment procedures and therefore be late, with the result that the loan becomes full recourse.

3.3.2.8. Violation of Single Purpose Entity. Especially in light of the <u>Cherryland Mall</u> and <u>51382 Gratiot Avenue</u> cases discussed in Section 2.2.2 above, I believe it should be a "deal point" for the borrower that a violation of this requirement be removed from springing full recourse status to one in which only the damages caused by the violation are reimbursable. After all, if the borrower acquiesces in the lender's foreclosure and does not file bankruptcy before or within a year after the foreclosure, the borrower's status as an SPE is irrelevant. So springing full recourse for a bankruptcy filing causes this provision to be moot -- unless the lender is seeking to trap an unsuspecting borrower/guarantor for something totally insignificant and harmless (absent a bankruptcy filing) such as a faulty invoice or under "SPE Catch 22" as was used in the <u>Cherryland Mall</u> and <u>51382 Gratiot Avenue</u> cases. My experience even before the <u>Cherryland Mall</u> and <u>51382 Gratiot Avenue</u> cases was that a request in as to this issue was generally accommodated by the lender. In the alternative, the borrower should review very carefully the SPE requirements in the loan documents and remove those -- at least from springing full recourse status -- that are not reasonable.

(a) The SPE requirement that is most commonly removed from springing full recourse status is the requirement that the borrower "maintain adequate capital in light of its contemplated business operations." See my discussion of the potential "SPE Catch 22" in subsection 3.2.2(j) of this outline.

(b) Other SPE requirements that should be considered are ministerial requirements with which a borrower may not generally comply, such as a requirement to "use separate stationery, invoices and checks bearing its own name."

3.3.2.9. Failure to Comply with Financial Reporting. I have had only one experience with a lender that insisted on a springing full recourse provision relating to financial reporting, and it resulted in the negotiation of an elaborate provision where (i) written notice with the words URGENT: IMMEDIATE ACTION REQUIRED was necessary at each stage of the process of late fees and potential liability, (ii) the borrower's prompt compliance with any written notice from the lender removed the failure from being a "liability strike" altogether (so that the next steps did not even apply to that failure), (iii) the first "liability strike" resulted in a small financial fee being due, (iv) the second "liability strike" resulted in a slightly larger financial fee being due, and (v) "liability strike three" resulted in springing full recourse.

3.3.2.10. Failure to Permit Inspections. While the purpose of such provision may be understandable, i.e., the borrower should not prevent a lender from inspecting its collateral, and while a default/acceleration provision in the loan documents might be warranted for a borrower's failure to provide reasonable cooperation with a lender's inspections after adequate advance notice from the lender, the "springing full recourse" provision is definitely overkill. In addition, the provision as recommended leaves open how the borrower can fail to "permit" an inspection by the lender. The concept of "failure to permit" brings out an image of a property manager standing on the property line with a shotgun. But if the lender's representative calls the property manager at 11PM and demands to inspect the property that night (because the lender's representative is just passing through town), must the property manager immediately rush over to the property with keys to all portions of the property or risk having the borrower and guarantor sued for the entire loan amount because the borrower did not "permit" the lender's inspection that night?

4. CONCLUSION

In my opinion, the lenders in the Cherryland Mall, 51382 Gratiot Avenue, Landmark Plaza, Pineridge Associates and Plummer Street Office cases that are summarized in Section 2.2.2 above have altered the assumptions under which borrowers have generally entered into loan negotiations. Those cases dramatically dispel any notion that non-recourse carve-out provisions won't be used by the lender as long as the borrower doesn't file bankruptcy or do any "bad boy" act that has the effect of stealing from the property. Instead, attorneys representing borrowers should discuss the Cherryland Mall, 51382 Gratiot Avenue, Landmark Plaza, Pineridge Associates and Plummer Street Office cases with their clients and should further discuss with their clients any provisions in the lender's loan documents that might be used to extract money from a borrower and/or guarantor despite the absence of any "bad boy" act.

APPENDIX

NOTE: This article was included in the June 2011 issue of *e*-Report that is published by the American Bar Association's Real Property, Trust and Estate Law Section.

AN UPDATED REPORT AND ANALYSIS ON SPRINGING RECOURSE GUARANTIES IN MORTGAGE LOAN TRANSACTIONS

by James H. Wallenstein

This article updates the author's article in the April 2009 issue of *eReport*, entitled "Springing Recourse Guaranties Enforced in Recent District Court Opinions: Will the Trend Continue? Should *In Terrorem* Provisions be Enforced?", which in turn had updated two excellent papers that had previously been presented by *eReport* Real Property Editor Cheryl Kelly [papers cited in footnotes to the April 2009 article]. As explained in the previous article, the term "springing recourse" refers to a feature of some mortgage loans where the loan is initially non-recourse, but the mortgage documents provide that the borrower and/or one or more guarantors will become liable for the **entire loan balance** (full recourse will "spring" into being) if certain prohibited acts occur. In this article the author will review four court opinions that have been issued since April 2009 and one additional currently pending litigation, and the author will analyze various rationales in the various court opinions dealing with "springing recourse" provisions in particular and penalties in general (with the term "springing recourse" to be used subsequently in this article without quotation marks).

1. Springing Recourse Provision Enforced for Borrower's Bankruptcy Filing

Following along the same lines as pre-2009 court opinions such as GCCFC 2006 - GG7 Westheimer Mall, LLC v. Edward H. Okun, U.S. Dist. LEXIS 64152 (S.D.N.Y. 2008) and First Nationwide Bank v. Brookhaven Realty Association, 637 N.Y.S. 2d 418 (N.Y. App. 1996), two court decisions rendered since this author's article in the April 2009 issue of *eReport* continue the trend of courts enforcing springing recourse provisions when the violation of the springing recourse prohibition was the borrower's filing for bankruptcy protection. Subject to the possibility of an exception in the currently pending Lightstone Holdings litigation that is discussed in Section 4 of this article, courts seem to be uniform in upholding bankruptcy-precipitated springing recourse.

111 Debt Acquisition LLC v. Six Ventures, Ltd. et al., 413 F. App'x 824 (6th Cir. 2011), with a summary accessible though the following web link: http://volo.abi.org/111-debt-acquisition-holdings-llc-v-six-ventures-l. The mortgage loan documents that were the subject of this litigation provided that the loan was non-recourse; however, three guarantors agreed that they would become liable for the entire loan balance upon a "Springing Recourse Event," one of which was the borrower's filing for bankruptcy. After having defaulted in its mortgage payments, the borrower filed for bankruptcy, which prompted the mortgagee to sue the guarantors for the full balance of the

$20,900,000 loan, claiming that the bankruptcy filing was a "Springing Recourse Event" under the guaranty. In an Opinion and Order dated February 18, 2009, the District Judge granted the mortgagee's motion for partial summary judgment, holding that the guarantors were liable for the full balance of the $20,900,000 loan. In his opinion the District Judge analyzed (i) whether or not the "Springing Recourse Event" provision in the guaranty and other loan documents was clear (in a quite extensive analysis, he found that it was clear), (ii) whether the mortgagee had followed proper trial procedure (he found that the mortgagee had done so), and (iii) whether the guaranty provision violated public policy by discouraging debtors from filing for bankruptcy protection (he found that it did not violate public policy). However, the District Judge's Opinion and Order [Case No. C2-08-768, U.S. District Court, S.D. Ohio, Eastern Division, Opinion and Order dated February 18, 2009, published at 2009 WL 414181, and also accessible through the following web site provided by *Justicia.com*: http://docs.justia.com/cases/federal/district-courts/ohio/ohsdce/2:2008cv00768/124806/102]
contains no discussion of whether the springing recourse provisions, which in this instance would cause the guarantors' liability to increase from zero to an amount approaching $20,900,000, might have prescribed an unenforceable "penalty" since the effect of the borrower's prohibited action appears to have resulted in nothing more than an approximately one-month delay in the mortgagee's foreclosure process. Similarly, the U.S. Sixth Circuit Court of Appeals analyzed only the language in the loan documents and failed to discuss the "penalty" issue, even though the somewhat related issue of public policy was briefed to the Court. See the following web link to a February 5, 2011 article entitled *"'Bad Boy' Guarantees and the Coming Commercial Real Estate Crisis,"* by Ohio attorney Teri Rasmussen in her blog on business law:
http://www.ohiopracticalbusinesslaw.com/2011/02/articles/real-estate/bad-boy-guarantees-and-the-coming-commercial-real-estate-crisis. That article contains links to the Appellant borrower's brief and the Appellee lender's brief in the Six Ventures, Ltd. litigation and then adds:

> Interestingly, both briefs make reference to a 2009 article by James H. Wallenstein entitled *"Springing Recourse' Guaranties Enforced in Recent District Court Opinions: Will the Trend Continue? Should In Terrorum Provisions Be Enforced?*" For those interested in the subject, this is indeed an article worth reading.

(Thanks, Teri. For the record, each side's attorney in the appeal did in fact mention this author's April 2009 *eReport* article, with the appellant arguing that the legal analysis in that article was spot-on and the respondent chiding the appellant for having no authority other than an American Bar Association article!)

UBS Commercial Mortgage Trust 2007-FL1, Commercial Mortgage Pass-through Certificates, Series 2007-FL1, and Normandy Reston Office, LLC v. Garrison Special Opportunities Fund L.P., Court Index No. 652412/2010, Decision and Order dated March 8, 2011, which can be which can be accessed through Index Case Number 652412/2010 at the following web site provided by the Supreme Court of the State of New York, New York County: http://iapps.courts.state.ny.us/iscroll/SQLData.jsp?IndexNo=652412%2F2010&Submit2=Search. A holder of mezzanine debt from a group of related mortgage borrowers agreed with the mortgagee ("UBS") that if the latter would agree to a forbearance period with regard to any foreclosure action, the mezzanine lender would guaranty the full amount of the loan if the borrower filed a voluntary bankruptcy petition after the forbearance period. The mezzanine lender ("Garrison") subsequently foreclosed on its mezzanine loan, thereby acquiring ownership of the borrowers' entities. And after that foreclosure, each of the mortgage borrowers filed a voluntary petition for relief under the

Bankruptcy Code. UBS then sued Garrison under Garrison's guaranty for payment in full of the mortgage loan. In defending against the mortgagee's lawsuit, Garrison argued both (1) that its guaranty was an unenforceable penalty and (2) that its guaranty was void as against public policy. Pointing out that Garrison was a sophisticated distressed real estate investor, the New York Supreme Court rejected both defenses and ruled in favor of UBS. The court filings accessible through the Court's web site (web link set out above) indicate (i) that Garrison always intended to pay off the UBS mortgage, which perhaps better explains the borrower's bankruptcy filing notwithstanding the springing recourse prohibition, and (ii) that this litigation appears to have been settled effective April 1, 2011.

2. Springing Recourse Provision Enforced for Borrower's Voluntary Subordinate Mortgage

Following along the same lines as pre-2009 court opinions such as Diamond Point Plaza Limited Partnership v. Wells Fargo Bank, N.A., 929 A.2d 932 (Md. 2007) (borrower's misapplication or conversion of rents and its failure to maintain its status as an SPE), Blue Hills Office Park LLC v. JP Morgan, 477 F. Supp. 2d 366 (D. Mass. 2007) (borrower's misapplication of settlement funds), and LaSalle v. Mobile, 367 F. Supp. 2d 1022 (E.D. La. 2004) (borrower's violation of the SPE restrictions by amending its organizational documents to permit business for any lawful purpose) -- but expressing rationales that this author will question in Section 6 below in this article -- one appellate court affirmed the trial court decision that had been reported in this author's April 2009 issue of *eReport* by affirming the trial court's enforcement of a springing recourse provision when the violation was a voluntary act of the borrower, totally within the control of the borrower, that was clearly in violation of the springing recourse prohibition.

CSFB 2001-CP-4 Princeton Park Corporate Center, LLC v. SB Rental I, LLC, 410 N.J. Super. 114, 980 A.2d 1 (App. Div. August 11, 2009), accessible through though the following web link to an article in *FindLaw* published by Thomson Reuters: http://caselaw.findlaw.com/nj-superior-court-appellate-division/1444523.html. This litigation involved a $13,300,000 mortgage loan to SB Rental I, LLC, which was non-recourse but subject to the possibility of springing recourse liability to the borrower and guarantors for the full $13,300,000 loan amount in the event that the borrower placed any subordinate financing on the property. During the term of the loan, the borrower placed a $400,000 subordinate mortgage on the property without having obtained the consent of the first lienholder; however, the borrower paid the subordinate financing in full a few months after having obtained that financing, and it appears that the first lienholder was not aware of the subordinate mortgage during the period of its existence. Several months after the $400,000 subordinate mortgage loan had been paid off, the borrower lost its sole tenant and stopped making payments under the $13,300,000 first lien mortgage. Shortly thereafter, the mortgagee instituted a foreclosure, which the borrower did not contest. Apparently, in reviewing the status of title during the foreclosure process, the mortgagee learned of the subordinate financing; and it then sued the borrower and the guarantors for a deficiency on the mortgage loan balance, arguing that the springing recourse provision had been activated by the borrower's subordinate financing. The borrower and the guarantors defended, arguing in part that since the mortgagee was not harmed in any way by the added encumbrance on the property, the springing recourse provision was an unenforceable penalty provision and should not be enforced. Both the trial court and the appellate court agreed with the lienholder, with the appellate court specifically addressing the "penalty" issue in the following analysis (the *italicizing* of certain statements below has been added by this author to indicate this author's disagreement with those statements, as will be explained further in Section 6 of this article):

> "Non-recourse carve-out clauses like the one here are not considered liquidated damages provisions *because they operate principally to define the terms and conditions of personal liability, and not to affix probable damages*. Generally speaking, because non-recourse loans may create issues of a borrower's motivation to act in the best interest of the lender and the lender's collateral, "lenders identified defaults that posed special risks and carved them out of the general nonrecourse provision." Portia Owen Morrison and Mark A. Senn, Carving Up the 'Carve-Outs' in Nonrecourse Loans, 9 Prob. & Prop. 8 (1995). These carve-outs, which are perceived to affect the value of the collateral that secures the loan, afford the lender the protection required by causing the debtor and any guarantors to be personally liable, thus enabling the creditor to look beyond simply the mortgaged property for repayment of the loan. In other words, whereas the non-recourse nature of the loan operates as an exemption, the carve-outs exist to implicate personal liability.
>
> "The carve-out clause is not a liquidated damages provision for yet another reason: it *provides for only actual damages*. Unlike the typical stipulated damages provision which reasonably estimates an amount otherwise difficult to compute, the carveout clause permits the lender to recover *only damages actually sustained, namely the amount remaining on the loan at the time of breach*. Such an amount is fixed by the terms of the loan and is therefore neither speculative nor incalculable. As noted, this action involves a loan made by plaintiff to SB Rental, who, along with the guarantors, agreed to its repayment, having received the full benefit of the contract. Plaintiff, in turn, made the loan with the assurance of full repayment. In filing this lawsuit, plaintiff simply seeks the amount left on the loan at the time of ultimate default. This amount is the actual damage to plaintiff based on defendants' failure to make mortgage payments. Since the carve-out clause imposes personal liability for *plaintiff's actual damages*, it is not a liquidated damages provision, much less an unconscionable penalty."

3. Springing Recourse Provision Not Enforced for Late Tax Payment

Since this author's April 2009 *eReport* article, one court has specifically addressed the penalty aspect of springing recourse provisions and has concluded that springing recourse should not be enforced in a scenario a bit different from the two scenarios discussed in Sections 1 and 2 of this article.

ING Real Estate Finance (USA) LLC v. Park Avenue Hotel Acquisition LLC, Supreme Court of the State of New York, New York County, Court Index No. 601860/2009, Decision and Order rendered February 24, 2010, accessible through Index Case Number 601860/2009 at the following web site provided by the Supreme Court of the State of New York, New York County:
http://iapps.courts.state.ny.us/iscroll/SQLData.jsp?IndexNo=652412%2F2010&Submit2=Search .
[NOTE: From the court documents available through the Supreme Court of New York web site, it appears that as of the date of preparation of this article, the *Park Avenue Hotel Acquisition* litigation

is still on-going.] In its February 24, 201 Decision and Order, the court declined to enforce a purported "Full Recourse Event" provision in a mortgage loan document, and in its opinion the court questioned whether a lender should be entitled to the benefit specified in that provision when the events triggering the guarantee are of little consequence, short duration, and do not injure the interest of the lender (in this case, a late tax payment promptly cured). And although much of the court's analysis in this case focused on the language of the particular loan documents, this author found particularly interesting the following two provisions. First, the court introduced the issue of full recourse with the following sentence:

> The question before the Court is whether, by the terms of the contract, the nineteen-day tardiness in paying less than $300,000 in property taxes triggers a full recourse obligation by the Guarantors of up to $90 million.

And second, in the following paragraph, especially the end of the paragraph, the court brought into question whether a springing recourse provision might be subject to classification as an unenforceable penalty:

> Finally, "[a] commercial agreement, of course, should not be interpreted in a commercially unreasonable manner or contrary to the reasonable expectations of the parties" (HGCD Retail Servs., LLC v 44-45 Broadway Realty Co., 37 AD3d 43, 49-50 [1st Dept 2006]). Immediate liability for the entire debt is not a reasonable measure of any probable loss associated with the delinquent payment of a relatively small amount of taxes. Here, pursuant to Section 9.3(d), plaintiffs would have moving defendants potentially liable for the entire debt of up to $145 million if the Borrower is just one day delinquent in paying a dollar in property taxes or any other debt for which a lien may be imposed. Such an unlikely outcome could not have been intended by the parties, sophisticated commercial borrowers and lenders aided by competent counsel at the time of the drafting, and is impermissible under New York law (see Truck Rent-A-Center, Inc. v Puritan Farms 2nd, Inc., 41 NY2d 420, 425 [1977] ("The rule is now well established. A contractual provision fixing damages in the event of breach will be sustained if the amount liquidated bears a reasonable proportion to the probable loss and the amount of actual loss is incapable or difficult of precise estimation. If, however, the amount fixed is plainly or grossly disproportionate to the probable loss, the provision calls for a penalty and will not be enforced."] [internal citations omitted]).

4. Currently Pending Litigation Regarding Springing Recourse for Bankruptcy Filing

In re Extended Stay Inc., 418 B.R. 49, 52 Bankr. Ct. Dec. (CRR) 47 (Bankr. S.D. N.Y. October 7, 2009), affirmed in part, 435 B.R. 139 (S.D. N.Y. September 7, 2010), which can be accessed through the following web site provided by *Justicia.com*: http://docs.justia.com/cases/federal/district-courts/new-york/nysdce/1:2009cv09731/355175/18; and **Bank of America, N.A., et al v. Lightstone Holdings, LLC**, et al, Case Index Number 601853/2009, Supreme Court of the State of New York, County of New York (representing the consolidation of U.S. Bank National Association v. Lightstone Holdings LLC et al., Index Case Number 651951/2009; Line Trust Corp. Ltd. et al. v. Lichtenstein et al., Index Case Number 601951/2010; and Bank of America NA et al. v. Lightstone Holdings LLC et al., Index Case Number 601853/2009), which can be accessed through Index Case Number 601853/2009 at the following web site provided by the Supreme Court of the State of New York, New York County:

http://iapps.courts.state.ny.us/iscroll/SQLData.jsp?IndexNo=652412%2F2010&Submit2=Search
This State of New York and federal Bankruptcy Court litigation has been reported in several sources, such as the following articles in the *Wall Street Journal* http://blogs.wsj.com/deals/2009/07/31/bad-news-for-extended-stays-bad-boy-lichtenstein and the Bloomberg web site http://www.bloomberg.com/news/2010-11-09/extended-stay-lender-sues-lightstone-holdings-over-100-million-guaranty.html. The litigation arose out of the June 2009 Chapter 11 bankruptcy filing by Extended Stay Hotels in the U.S. Bankruptcy Court for the Southern District of New York. Shortly after the bankruptcy filing, the certain mortgage and mezzanine lenders of funds to the bankrupt entity initiated litigation in New York state court against the conditional carve-out guarantors (often referred to as "bad boy" guarantors), alleging that the bankruptcy filing was a springing recourse violation that caused the guarantors to become liable for up to $100 million of debt. After an initial removal of that New York state proceeding to the federal Bankruptcy Court in September 2009, both the Bankruptcy Court and the Federal District Court held that the issue of enforceability of springing recourse provisions is a matter for state courts, not the Bankruptcy Court. Accordingly, the springing recourse claim was remanded back to the New York state court, where according to documentation available on the New York Supreme Court web site as of the date that this article is being prepared, it is still pending. [NOTE: As indicated in the *Wall Street Journal* article that is cited above, this litigation is further complicated by the apparent agreement between the individual guarantor and one or more of the bankrupt's lenders, whereby the lender(s) would indemnify the individual guarantor from his springing recourse liability in exchange for the guarantor's giving the senior lenders control of the bankrupt's operations. In fact, while the documentation currently available on the New York Supreme Court web site indicates that the state court action is still pending, the Spring 2011 article entitled *"Bad Boy" Guaranties and Protecting Yourself from Acts of Others,"* by New York attorneys Samuel M. Walker and David Brier, which is available at the following Blank Rome LLP web site http://www.blankrome.com/index.cfm?contentID=37&itemID=2450, reports that the individual guarantor was held jointly and severally liable with his company for a $100 million guarantee, with the article also stating: "The court enforced the clause and the investors of the senior lender subsequently indemnified him."]

5. The Trend Clearly is in Enforcing Springing Recourse Provisions

See the following recent articles on the subject, all of which are located on readily accessible internet web pages:

> Zagoren, Boltryk and Hackman, *Testing the Limits of Recourse Carve-Out Guaranties,* Real Estate Finance Journal (Spring 2010)
> *http://docs.google.com/viewer?a=v&q=cache:hJb03DYQ3WIJ:www.dechert.com/library/3-10-Real_Estate_Finance_Journal-Testing_the_Limits-Zagoren_Boltryk_Hackman.pdf+GCCFC+2006+-+GG7+Westheimer+Mall,+LLC+v.+Edward+H.+Okun&hl=en&gl=us&pid=bl&srcid=ADGEESgynKCrOs_aZy3EY4FCjxAzopWBEn53XwTpzPw01nf3lHPPGpDNjem7VTGcvnKgVIXgxoVnCX9pgBVcsrs3VJMbYmWCHXYnIuQ7voz3C9iPybjnaoBTlSLFH_3hOYFwiiZ0M8vl&sig=AHIEtbQTwxHyDLskMx1QNTb2Jo8CmhyeWA*

Kelly, *Real Estate Work-Outs: Running Dry in the Liquidity Crunch?* http://files.ali-aba.org/thumbs/datastorage/skoobesruoc/pdf/TSNR01_chapter_02_thumb.pdf (June 2008);

Kuney, *"Springing Guarantee" Fully Enforced in Non-recourse Mortgage Loan: for Borrower's Loan Breaches Including the Failure to Comply with Separateness Covenants*, www.sidley.com/db30/cgi-bin/pubs/Bankruptcy_Update_08.20.07.pdf (August 2007); and

Murray, *Carveouts to Nonrecourse Loans: They Mean What They Say!* http://www.firstam.com/content.cfm?id=2920 (2007).

As indicated in these articles, the trend of courts ruling on springing recourse provisions in mortgage loan documents is clearly in favor of enforcing the provisions.

6. Questionable Rationales for Enforcement of Springing Recourse Provisions

This author questions certain of the rationales used in many of the decisions enforcing springing recourse provisions, believing that courts often either have not considered the issue of "penalty" at all or have incorrectly discarded the issue as it relates to a contract provision that purports to increase a party's liability from zero to the entire loan balance, regardless of the harm that was caused to the lender by the springing recourse violation. The "penalty" issue will be discussed further in Section 7 of this article; however, perhaps an analysis of two rationales used in a recent court opinion enforcing springing recourse provisions will serve as a helpful preface. Each of the rationales was highlighted by *italics* in excerpts from the New Jersey appellate court's decision in SB Rental I, LLC that is quoted in part in Section 2 above.

Terms of Liability, Not Damages.

The New Jersey appellate court in its SB Rental I, LLC decision stated in part (with the *italicizing* below having been added by this author to indicate this author's disagreement with the statement italicized): "Non-recourse carve-out clauses like the one here are not considered liquidated damages provisions *because they operate principally to define the terms and conditions of personal liability, and not to affix probable damages*." That statement reflects a rationale similar to the following: (i) the lender made a loan, and a borrower customarily has liability for repaying a lender's loan; (ii) in the particular loan in question the lender made a unique exception, granting the borrower and its guarantor(s) exculpation from the repayment obligation if, but only if, the borrower "kept its end of the bargain" by refraining from the specified springing recourse activities; (iii) since the borrower did not so refrain, the borrower and the guarantor(s) were not entitled to the lender's unique exception, and the customary obligation of repayment returned. But that rationale does not, in the opinion of this author, reflect the essence of the business deal struck between the lender and the borrower at the commencement of the mortgage loan transaction. It is the opinion of this author that the business dialogue in most mortgage loan transactions generally follows a format such as the following:

> Borrower (*before any loan commitment is issued*): "The loan is a non-recourse loan, right?"
>
> Lender: "Yes, that's the deal."
>
> Borrower (*after receiving the lender's loan commitment*): "I see the paragraph that says the loan is non-recourse, but it mentions something about your customary carve-out provisions. What are those?"
>
> Lender: "Don't worry about that; it's just our legal department's standard stuff. Your lawyer can work out the language with our lawyer in the final loan documents."
>
> Lender's Lawyer to Borrower's Lawyer (*during document negotiations*): "The commitment says the documents will contain our customary carve-out provisions, and the springing recourse paragraph is standard for us. I don't have the authority to delete it. Just tell your client not to do anything that is prohibited by the paragraph, and there won't be any problem."

While no research has been done other than the author's recollection of his professional experience during the past 40 years (with non-recourse carve-out liability being a significant aspect of mortgage loan transactions during at least 20 of those 40 years) to justify the above-quoted scenario, the author believes that a polling of lenders and borrowers about their pre-commitment and contemporaneously-with-commitment verbal dialogue would reveal scenarios very similar to what is quoted above. And, more importantly, the author believes that not a single lender would have answered the borrower's first question in the above scenario with an analysis similar to what was set out in the above-quoted statement from New Jersey appellate court's decision in <u>SB Rental I, LLC</u>. It is this author's belief that if lenders were polled about why springing recourse provisions are included in their loan documents, not a single one would say that the principal purpose of the springing recourse provisions was to, as the New Jersey appellate court stated, "define the terms and conditions of personal liability."

<u>Liability Only for Actual Damages</u>.

As also discussed and quoted in Section 2 of this article, the New Jersey appellate court in its <u>SB Rental I, LLC</u> decision also stated (with the *italicizing* below having been added by this author to indicate this author's disagreement with the statements italicized): "The carve-out clause is not a liquidated damages provision for yet another reason: it *provides for only actual damages*. . . . [t]he carveout clause permits the lender to recover *only damages actually sustained, namely the amount remaining on the loan at the time of breach*. . . . Since the carve-out clause imposes personal liability for *plaintiff's actual damages*, it is not a liquidated damages provision, much less an unconscionable penalty." With regard to the rationale that the loan balance is nothing more than the lender's actual damages, this author believes that such rationale mistakenly confuses the effect to the lender of the borrower's failure to repay the loan (which is not a recourse event -- to the contrary, it is the very basis for the non-recourse exculpatory language) with the damages caused to the lender by the borrower's taking an action that is proscribed in the springing recourse provision. And the fact situation in the SB Rental I, LLC litigation is an excellent example, since the subordinate loan that the borrower had consummated in violation of the springing recourse prohibition had been fully satisfied before the borrower's default under the non-recourse loan, so that the guarantors were held liable for a $13,300,000 loan amount although the lender unarguably had suffered no damage whatsoever from the violation. In fact, the rationale as to "actual damages" that is used by the New Jersey appellate court in its SB Rental I, LLC opinion is in direct conflict with the analysis of the Supreme Court of the State of New York, New York County, in the Park Avenue Hotel Acquisition litigation that is discussed and quoted in Section 3 of this article. In addition, while this author does not agree in full with the rationale used by another judge on the Supreme Court of the State of New York, New York County, in the Garrison Special Opportunities Fund litigation (the second case discussed in Section 1 of this article) in upholding the springing recourse provisions of the loan documents in that litigation, this author notes that in the following portion of the Garrison Special Opportunities Fund opinion, where the Court attempts to distinguish its holding from the Park Avenue Hotel Acquisition decision, the Garrison Special Opportunities Fund opinion at least indicates an agreement with this author that only the damages actually caused by the springing recourse violation are what should be considered, i.e., that the entire principle balance of the loan is not automatically a lender's "actual damages" for any springing recourse violation:

"Such features [*NOTE: It appears from the context of this sentence within the opinion, especially the Court's apparent agreement with the* Park Avenue Hotel Acquisition *opinion, that "such features" means only the feature of springing recourse for a bankruptcy filing, not all springing recourse provisions*.] are not unenforceable penalties and plaintiffs reliance on ING Real Estate Finance (USA) LLC v Park Avenue Hotel Acquisition LLC, 2010 WL 653972 (NY Sup Ct 2010) is readily distinguished. There the court was dealing with the triggering of a guaranty by the filing of a tax lien, which was discharged during the cure period. The court found there that lender had not suffered damages during the brief period the lien was extant and declined to impose a deficiency judgment after foreclosure. Accordingly, the court finds the Guaranty here, in the circumstances, not to be an unenforceable penalty."

7. Analysis of "*In Terrorem*" Contract Provisions and "Penalty"

As stated in Section 6 above, it is this author's belief that if lenders were polled about why springing recourse provisions are included in their loan documents, not a single one would say that the principal purpose of the springing recourse provisions was to give the lender full-recourse remedies. Instead, they would say that such springing recourse provisions are included to make it prohibitive for the borrower to act improperly -- what some courts and commentators refer to as ***"in terrorem"*** provisions, i.e., contractual provisions whose primary purpose is to place the borrower ***in terror*** against performing a proscribed action. This conclusion is corroborated by occasional references in speech presentations where the speaker uses the term "*in terrorem*" to describe the springing recourse provisions, such as the following: Barton, *Carveouts, Deficiencies, and In Terrorum Clauses*, 2004 University of Texas Mortgage Lending Institute; and Weller, *Bankruptcy in Terrorum Clauses*, 1995 University of Texas Mortgage Lending Institute.

Other than perhaps in the context of will contests, *in terrorem* provisions are not favored by courts. As explained in 24 WILLISTON ON CONTRACTS, § 65:3, page 249: "Accordingly, a specified sum that is unreasonably large when compared to the damage that could have been anticipated from the breach of the contract, and therefore punishes the breach, is a penalty, as is a sum which is designed to or has the effect of coercing performance of the contract by making the breach so expensive that it forces adherence to the contract." A similar statement is found in Farnsworth, CONTRACTS §12.18 at 841 (3d ed. 1999): "Enforcement of [*in terrorem*] provision[s] would allow parties to depart from the fundamental principle that the law's goal on breach of contract is not to deter the breach by compelling the promissor to perform, but rather to redress the breach by compensating the promissee. It is this departure that is proscribed when a court characterizes such a provision as a penalty." See also, among many other sources, the following general analyses on the subject: RESTATEMENT OF THE LAW (SECOND) OF CONTRACTS (1981), pages 157-61, § 356 ("Liquidated Damages and Penalties"); and 24 WILLISTON ON CONTRACTS, pages 248-57, §§ 65:3 and 65:4 ("Distinction between penalties and liquidated damages"). *Accord*: Section 2-718 of the Uniform Commercial Code (entitled "Liquidation or Limitation of Damages; Deposits"), which states in subsection (1): "Damages for breach by either party may be liquidated in the agreement but only at an amount which is reasonable in light of the anticipated or actual harm caused by the breach, the difficulties of proof of loss, and the inconvenience or non-feasibility of otherwise obtaining an adequate remedy. A term fixing unreasonably large liquidated damages is void as a penalty." See also U.C.C. §2A-504 (entitled "Liquidation of Damages") and the analysis of both U.C.C. provisions in Shrank and Yim, "Liquidated Damages in Commercial Leases of Personalty - The Proper Analysis," 64 *ABA Business Lawyer*, Issue 3, page 757 (2009).

The United States Supreme Court provided analysis on this subject in 1947, in <u>Priebe & Sons, Inc. v. United States</u>, 332 U.S. 407, 413 (1947), even using the term *in terrorem* in its decision:

> It might, as respondent suggests, have an *in terrorem* effect of encouraging prompt preparation for delivery. But the argument is a tacit admission that the provision was included not to make a fair estimate of damages to be suffered but to serve only as an added spur to performance. It is well-settled contract law that courts do not give their imprimatur to such arrangements.

Other courts have similarly used the term *in terrorem* pejoratively, or have expressed philosophy comparable to the Supreme Court's statement in <u>Priebe & Sons</u>. For example, in the case of <u>Muller v. Light</u>, 538 S.W.2d 487 (Tex. Civ. App. -- Austin 1976), the court characterized a purported liquidated damages provision in a construction contract to be "an *in terrorem* device to insure prompt performance by the builder" and, accordingly, an unenforceable penalty. Similarly, in <u>Raffel v. Medallion Kitchens of Minnesota, Inc.</u>, 139 F.3d 1142 (7th Cir. 1998), the court found a purported liquidated damage provision in a lease to be an unenforceable penalty and, in doing so, favorably quoted the following language from a 1915 opinion from the Illinois Supreme Court: ". . . if it [the damage clause in a contract] appears to have been inserted to secure the prompt performance of the agreement, it will be treated as a penalty and no more than actual damages can be recovered." 139 F.3d at 1146. The same court later cited its Raffel opinion favorably and described the basis for its decision with essentially the same language in its opinion in Checkers Eight Limited Partnership v. Hawkins, 241 F.3d 558, 562 (7th Cir. 2001), in holding unenforceable a stipulated fee for failing to make a settlement payment within the prescribed time period. Accord: In re Dow Corning Corp., 419 F.3d 543 (6th Cir. 2005) and MCA Television Limited v. Public Interest Corporation, 171 F.3d 1265, 1271 (11th Cir. 1999), which opinions are listed in support of the above-quoted statement in 24 WILLISTON ON CONTRACTS.

For a sampling of real estate related court opinions in the author's State of Texas on the issue of penalty versus liquidated damages, see Flores v. Millennium Interests, Ltd., 185 S.W.3d 427 (Texas Supreme Court 2005) (characterizing as an unenforceable penalty a statutory "liquidated damage" provision in connection with a contract for deed); Stewart v. Basey, 245 S.W.2d 484 (Texas Supreme Court 1952) (characterizing as an unenforceable penalty a liquidated damage provision in a lease agreement); Tri-Cities Construction, Inc. v. American National Insurance Company, 523 S.W.2d 426 (Tex. Civ. App.--Houston [1st Dist.] 1975, no writ), appeal after remand, 551 S.W.2d 106 (Tex. Civ. App.--Houston [1st Dist.] 1977, no writ) (holding a mortgage loan commitment fee to be an unenforceable penalty); Ashton v. Bennett, 503 S.W.2d 392 (Tex. Civ. App.--Waco 1973, writ ref'd n.r.e.) (holding an earnest money deposit in a real estate contract of sale to be an unenforceable penalty).

To be sure, some courts and scholars have at times questioned, as did Judge Richard A. Posner in his often-cited decision in Lake River Corporation v. Carborundum Company, 769 F.2d 1284 (7th Cir. 1985), "whether a modern court should refuse to enforce a penalty clause where the signator is a substantial corporation, well able to avoid improvident commitments." 769 F.2d at 1288-89. However, that quoted language, as well as other language in Judge Posner's decision questioning the wisdom of the "penalty" characterization where sophisticated parties are involved, was clearly *dicta* in that the Court in Lake River Corporation did in fact find the contract provision in question to be an unenforceable penalty, with Judge Posner even commenting that "Illinois courts resolve doubtful cases in favor of classification as a penalty." 769 F.2d at 1290. And despite comments by some courts and scholars along the lines of Judge Posner's comments in his Lake River Corporation opinion [with recent judicial authority in the United Kingdom for a "commercial justification" test imposed upon the "penalty" concept, as explained in Baron, "The Doctrine of Penalties and the Test of Commercial Justification," 34 *University of Western Australia Law Review* 42 (2008), which cites considerable United States authority and treatises as well as United Kingdom authority and treatises], and despite at least one law review analysis suggesting that courts should substitute the doctrine of "unconscionability" for the "penalty" rule, Note and Comment (David Brizzee), "Liquidated Damages and the Penalty Rule: A Reassessment," *Brigham Young University Law Review* (1991), the appellate decisions cited above in this Section 7 (many of which post-date the Lake River Corporation opinion) demonstrate that courts have uniformly continued to acknowledge the "penalty" concept in evaluating contractual provisions that grant remedies after a party's default. In addition, not only have U.C.C. §2-187 and U.C.C. §2A-504 (both cited above in this Section 7 and requiring reasonableness without regard to the sophistication of the parties) continued to be the applicable statutory law in almost all States well after Judge Posner's Lake

River Corporation opinion, but as explained in footnote 3 of the 64 *ABA Business Lawyer* article cited in full above in this Section 7, U.C.C. §2A-504 was actually first proposed to the States by the American Law Institute and the National Conference of Commissioners on Uniform State Laws in 1987, i.e., after the publication of the Lake River Corporation opinion.

8. Fact Scenario for Evaluating Whether a "Penalty" or "Unconscionability" Evaluation Might be Warranted for Springing Recourse Provisions

In addition to the rationales of some courts along the lines discussed in Section 6 of this article, it is also this author's opinion that comments made by judges in many of the opinions involving springing recourse often reflect the judges' disapproval of and impatience with certain specific prior actions and/or court arguments of the respective defendants. And since the "penalty" concept is essentially an equity concept [see for example, the historical analyses in Lloyd, "Penalties and Forfeitures," 29 *Harvard Law Review* 117 (1915), and later in Comment (Jeffrey B. Coopersmith), "Refocusing Liquidated Damages Law for Real Estate Contracts: Returning to the Historical Roots of the Penalty Doctrine," 39 *Emory Law Journal* 267 (1990)], perhaps courts are applying their own equity evaluations without expressly acknowledging that procedure. In addition, perhaps courts are even following without acknowledgment the suggestion by student author David Brizzee in his *Brigham Young University Law Review* Note and Comment that was cited in full in the immediately preceding paragraph, by which the courts are weighing the contractual springing recourse in their cases against a standard of "unconscionability" instead of the "penalty" standard and are holding in favor of the lenders because they have concluded that the situations being litigated did not cross the "unconscionability" threshhold. [Although, as explained in another article by Australian law professor Paula D. Baron where both United States law and United Kingdom law are thoroughly cited, the "unconscionability" concept is itself not without problems. Baron, "Confused in Words: Unconscionability and the Doctrine of Penalties," 34 *Monash Univesity Law Review* 285 (2008)]. This author predicts a different line of reasoning, i.e., with a thorough analysis of the "penalty" and/or "unconscionability" aspects of *in terrorem* clauses, in a future court decision where the judge perceives, as did the Supreme Court of the State of New York, New York County, in its Park Avenue Hotel Acquisition opinion that is discussed and quoted in Section 3 of this article, that the borrower's actions were innocent as to motivation and caused little or no harm to the lender. And this author would especially predict a court's rejection of the springing recourse remedy in the event of deficiency litigation involving facts comparable to the following (with apologies to non-Texas readers for the frequent use of Texas law in the following scenario):

- The loan transaction was a $10 million mortgage loan which was non-recourse loan but with a few "springing full recourse" provisions.

- The property is a single-tenant building which the borrower maintained in good condition.

- The tenant in the property left at the end of its lease term, and the borrower was not able to obtain another tenant for the property.

- The borrower advised the lender that it would not be able to pay the mortgage without a tenant, and the borrower then cooperated with the lender's foreclosure.

- Although the property was likely worth almost, if not all, of the amount of the loan balance, the lender purchased the property at the foreclosure sale for $1 million, i.e., 10% of the loan balance, thereby leaving a deficiency of $9 million. Following well-established case authority in Texas, the lender was very careful to conduct the sale precisely in accordance with the Texas procedural requirements so that absolutely no irregularity can be shown. See American Savings & Loan Ass'n v. Musick, 531 S.W.2d 581 (Tex. Sup. Ct. 1975), which held that a bid of 7.4% of fair market value, without foreclosure irregularity, was not a sufficient basis to raise a fact issue in opposition to a summary judgment upholding foreclosure in favor of the mortgagee. See also another opinion by the Texas Supreme Court, which had rendered a similar ruling ten years earlier. Tarrant Savings Ass'n v. Lucky Homes, Inc., 390 S.W.2d 473 (Tex. Sup. Ct. 1965). And also see the following language in the U.S. Fifth Circuit's opinion in Savers Federal Savings & Loan Association v. Reetz, 888 F.2d 1497, at 1503 (5th Cir. 1989), where the court concluded its analysis of the Texas Supreme Court's opinion in the Musick case cited above, as well as other relevant Texas authorities, as follows: "We conclude under controlling and long-established Texas law that where there has previously been a valid nonjudicial deed of trust foreclosure on real property securing a debt, the amount to be credited to the debt for deficiency purposes is the amount received at the foreclosure sale; . . ." For those who may be having a recollection of a so-called "70% rule of thumb" for foreclosure bidding (i.e., a recommended practice of bidding at least 70% of the fair market value at a foreclosure sale), that rule of thumb had its origin in *dicta* that had been included in the U.S. Fifth Circuit's opinion in Durrett v. Washington National Insurance Co., 621 F.2d 201 (5th Cir. 1980), which had held the Texas non-judicial foreclosure sale in that case to have been a "fraudulent transfer" under the federal bankruptcy laws because the bid price was not of "reasonably equivalent value" as required by the bankruptcy laws in that situation, and the Court then indicated that the particular non-judicial foreclosure sale likely would not have been so labeled if the bid price had been at least 70% of the fair market value of the property. The Durrett rule of thumb lasted for 14 years, but it was overturned by the United States Supreme Court in the case of BFP v. RTC, 511 U.S. 531 (1994), where the Supreme Court ruled that a foreclosure sale would not be vulnerable to "fraudulent transfer" characterization under the bankruptcy law "so long as all the requirements of the State's foreclosure laws have been complied with." 511 U.S. at 545.

- Within six months after the foreclosure sale, the lender located a party who wanted to own and conduct business from the property, and the lender soon thereafter sold the property to that party for a purchase price equal to the sum of the full amount of the loan balance, plus all unpaid interest and the lender's expenses relating to the loan and foreclosure.

- During the period after the foreclosure sale, the lender learned that without the consent or even knowledge of the guarantor a 1% limited partner in the limited partnership comprising the borrower had during the loan term assigned one-half of his interest to a business associate; and even though the 1% interest had no voting control or veto rights as to the actions of the borrower, that 0.5% conveyance violated the very clear unambiguous restrictions in the mortgage against "Transfer" (defined in the mortgage to include the transfer of a partnership interest), which in turn caused the very clear unambiguous springing recourse provisions of the guaranty to be in effect as to the guarantor.

- Despite the lender's break-even result with regard to the loan, and despite the lack of any damage suffered by the lender in connection with the "Transfer" violation caused by the 0.5% assignment, the lender sued the guarantor for the 90% deficiency amount, i.e., $9 million, arguing that the springing recourse event caused the guarantor's status to change from non-recourse to full recourse.

- The trial judge in the deficiency case does not suspect the Borrower of having drained the property, instead believing that the borrower acted admirably with regard to the property but succumbed to the loss of its single tenant and a generally declining real estate economy.

- Although the price bid at the foreclosure by the lender was clearly lower than the fair market value of the property, and although Texas does have post-foreclosure deficiency-limitation statutes that permit a guarantor to offset the debt with the fair market value of the property, the original loan documents contained a waiver by the guarantor of all benefits under the post-foreclosure deficiency-limitation statutes. And while the trial judge in the deficiency case would prefer to follow this author's 1991 analysis (published in a State Bar of Texas publication the year that the post-foreclosure deficiency-limitation statutes were enacted in Texas) as to why such waivers should be held to be unenforceable, the trial judge concludes, in light of two new-millennium appellate cases, that a trial judge in Texas must honor the guarantor's waiver. LaSalle Bank, N.A. v. Sleutel, 289 F.3d 837 (5th Cir. 2002); Segal v. Emmes, 155 S.W.3d 267 (Tex. App. - Houston [1st Dist.] 2004), petition denied.[4]

- The guarantor's attorney thoroughly briefs for the trial judge the "penalty" issue, including the opinion of the Supreme Court of the State of New York, New York County, in the Park Avenue Hotel Acquisition decision that is discussed and quoted in Section 3 of this article.

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4 As a 2013 update of the above reference to the LaSalle Bank, N.A. v. Sleutel and Segal v. Emmes decisions, see the following two decisions recently issued by the Dallas Court of Appeals: Interstate 35/Chisam Road, L.P. v. Moayedi, 377 S.W.3d 791 (Tex. App.- Dallas 2012), with a petition for appeal to the Texas Supreme Court having been filed on January 7, 2013, which is accessible through http://data.scotxblog.com/scotx/no/12-0937, but with no further action having been reported as of the date that this outline is being prepared; and Smith v. Town North Bank, Case No. 05-11-00520-CV (Texas App. – Dallas, opinion issued November 13, 2102), which is accessible through http://www.leagle.com/xmlResult.aspx?page=1&xmldoc=In TXCO 20121113587.xml&docbase=CSLWAR3-2007-CURR&SizeDisp=7, no writ history to date. In its opinion in Moayedi, the appellate court expressly followed LaSalle Bank, N.A. v. Sleutel and Segal v. Emmes (with the Smith opinion, in turn, expressly following Moayedi), and in Moaydi the principle of waiver was applied to a set of loan documents where the only contractual waivers were generic waivers of "any defense" and "all rights and remedies of surety," with no mention of the Texas post-foreclosure deficiency-limitation statutes, nor even of offset rights in general.