

Incredibly insightful way of handling a foreclosure written by one of our trusted advisors, attorney Marc Joseph.

I am writing about a topic that I have spent significant time negotiating over the years- non-recourse loans and non-recourse carve-outs. Together some of us have spent significant time discussing areas of potential exposure. One area I expressed particular concern about is the “insolvency” SPE covenant. A brief explanation...

Nearly every non-recourse guaranty includes exposure for violating the “SPE covenants”. These SPE covenants usually include requirements to “remain solvent” and “maintain adequate capital” The failure to adhere to these requirements is usually a full-recourse trigger (at least in the first draft). The question that jumps out is....“If the property is underwater because of a valuation issue or loss of tenants (not because of any bad-boy acts), is the borrower “insolvent” and does this trigger full recourse liability?” Many people have said that this just can’t be. Such a conclusion would result in nearly every failed real estate project triggering guaranty liability and the loan was supposed to be non-recourse! Inability to pay because of loss of tenants or another valuation issues is not a bad-boy act. The fact that the deal became insolvent (while unfortunate) was not in-and-of-itself supposed to trigger liability.

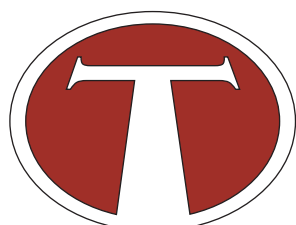
Until now, I could not find a court case that supported the argument that the mere “insolvency” of a borrower would violate the SPE covenant and, therefore, trigger full recourse. The case law has been leading up to this conclusion for years. Thus, I have spent hours negotiating carve-outs with lenders on the fear that a court could interpret the insolvency carve-out in such a way. We now have such a case.

Recently, a Michigan appellate court issued its opinion in the case of Wells Fargo Bank vs Cherryland Mall. I have attached a copy of the case. In summary, the court imposed liability upon the individual carve-out guarantor for over \$2,000,000 of deficiency liability after a mortgage foreclosure. The theory....the Borrower was insolvent (assets worth less than liabilities) when the mortgage was foreclosed and this insolvency violated the SPE covenants of the loan. The guaranty in question imposed full-recourse for SPE covenant violations and, therefore, triggered full recourse liability to the guarantor for the amount of the deficiency judgment.

Entirely eliminating carve-out liability for SPE violations is nearly impossible in today’s CMBS world. However, we have tried to negotiate carefully crafted modifications and exclusions to this “insolvency trap.” These are now more important than ever. As you negotiate your loans in the coming year, pay particular attention to the SPE covenants requiring insolvency and adequacy of capital. Make sure the documents expressly provide that the failure to remain solvent or maintain adequate capital does not trigger recourse liability. Most lenders will be sympathetic to these changes in one form or another. We now have a case to point to when the lender accuses us of being paranoid.

All the best for a happy, healthy, and prosperous 2012 and I hope that we can be of service in the coming year.

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