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Court finds recourse liability against a guarantor due to borrower insolvency

Michigan Court of Appeals Opinion

On December 27, 2011, the Michigan Court of Appeals published *Wells Fargo Bank, NA v. Cherryland Mall Limited Partnership et al.*, 2011 WL 6785393 (Mich. App. Dec. 27, 2011), which for the first time holds that a non-recourse mortgage loan backed by commercial mortgage backed securities ("CMBS") will give rights of recourse against the borrower and the loan guarantor when the borrower violates a solvency covenant.

Facts

In 2002 borrower Cherryland Mall LP closed an $8.7 million loan with Archon Financial, LP, secured by the Cherryland Mall property near Traverse City, Michigan. Defendant David Schostak guaranteed the loan. The loan package was assigned to Wells Fargo Bank, which placed it into a real estate mortgage investment conduit trust (REMIC), governed by a pooling and servicing agreement, under which Wells Fargo was trustee.

After default in 2009, Wells Fargo foreclosed on the mall by advertisement, and on August 10, 2010 Wells Fargo successfully bid $6.0 million at the sheriff's sale, leaving a $2.1 million deficiency. The bank immediately filed suit to collect the deficiency, later amending its complaint to add claims against Mr. Schostak individually arising out of his guarantee. The loan documents all provided that recourse against the borrower and guarantor arose if the borrower lost its special purpose entity, or "SPE" status. As the court explained, this status is acquired through a series of covenants that isolates the primary security—here the mortgaged Cherryland mall—from other creditors. The amended complaint alleged Cherryland's insolvency caused it to lose SPE status, thus giving the bank recourse against Cherryland and Mr. Schostak.

Following the close of discovery, the Grand Traverse County Circuit Court granted several summary judgment motions, but on appeal, defendants challenged only the judgment against Mr. Schostak and an attorney fee award.

Analysis of a typical CMBS transaction

The Court of Appeals first explained generally the nature of a CMBS loan, quoting the description given to such transactions by the Commercial Mortgage Securities Association and Mortgage Bankers Association:[i]

> One of the bedrock elements of a CMBS financing is the isolation of the asset to be financed. This is the essential bargain between borrower and lender that permits financing on a non-recourse basis: the lender agrees not to pursue recourse liability directly or indirectly against the borrower or its owners, provided that the lender can comfortably rely on the assurance that the financed asset will be "ring-fenced" from all other endeavors, creditors and liens related to the parent of the property owner or affiliates, and from the performance of any asset owned by such parent entity or affiliates. More specifically, it is not just the isolation of the real property asset, but the isolation of the cash flows coming from the operation of the real property,

> from which debt service is paid on the mortgage loan and subsequently distributed to the holders of the securities issued backed by such mortgages....
>
> The twin components of asset isolation are (i) separateness covenants (the “Separateness Covenants”) and (ii) narrow limitations on the lender’s general agreement not to pursue recourse liability (the “Limited Recourse Provisions”) ....
>
> The Separateness Covenants, while often referred to and discussed as a unitary concept, are really a package of separate and independent covenants made by a borrower to a CMBS lender. The following is a sample set of Separateness Covenants, taken from the form documents for a CMBS lender:

The court further described two typical CMBS loan “triggers” that will imperil borrowers or guarantors with recourse. The first trigger requires the borrower or guarantor to engage in “bad acts”, such as fraud, intentional misrepresentation, misappropriation of rents during default, misappropriation of insurance proceeds, actual waste, or arson. If such acts are proven, the bank has recourse, but in an amount limited to actual damages caused by those acts, which may not be equivalent to the loan deficiency balance.

The second type of recourse trigger, (again, the court here describing a typical transaction) allows the bank to recover the entire unpaid loan balance, plus accrued interest, for the borrower’s breach of the “separateness covenants”, e.g., breach of “due on transfer” or “due on encumbrance” clauses, or “any voluntary or collusive involuntary bankruptcy or insolvency filing” by the borrower.

<u>The Court undertook a detailed analysis of the contract to establish a right to recourse</u>

After its discussion of typical non-recourse CMBS transactions, the Court of Appeals turned to the trial court’s judgment against Mr. Schostak on his guarantee. It noted the trial court held that Cherryland’s insolvency triggered recourse under the second “trigger”, that is, Cherryland’s insolvency violated a separateness covenant that caused it to lose SPE status.

However, the Court of Appeals also determined the trial court erred by failing to indentify a definition of an SPE (which the documents lacked) and for failing to take extrinsic evidence on the issue. Despite these deficiencies in the trial court record, the court found the loan documents to be unambiguous, and held that the meaning of “SPE” was apparent when reading all loan documents together. The court supported its conclusion by reference to the relevant language from the loan documents:

> The note, mortgage, and guaranty all provide, in nearly identical language, that the loan debt becomes fully recourse as to the borrower (mortgage and note) or guarantor (guaranty) in the event that Cherryland “fails to maintain its status as a single purpose entity as required by, and in accordance with the terms and provisions of the[/this] Mortgage.”
>
> Paragraph 9 of the mortgage provides as follows:
>
> **9. *Single Purpose Entity/Separateness***. Mortgagor covenants and agrees as follows:
>
>> (f) *Mortgagor is and will remain solvent and Mortgagor will pay its debts and liabilities (including, as applicable, shared personnel and overhead expenses) from its assets as the same shall become due.*

The defendants argued par. 9(f) above did not clearly establish that solvency was required for Cherryland to maintain its SPE status. The Court of Appeals disagreed, but went to great lengths to reach its conclusion, extensively analyzing the loan document merger clauses, clauses regarding the significance of "headings" within the documents, and legal doctrines regarding interpreting related documents. The court concluded that both the "separateness covenants" and very narrow limits on the bank's agreement not to pursue recourse combined to create SPE status, even in the absence of a clear definition:

> "[o]ne of the bedrock elements of a CMBS financing is the isolation of the asset to be financed" and that "[t]he twin components of asset isolation are (i) separateness covenants ... and (ii) narrow limitations on the lender's general agreement not to pursue recourse liability."… [S]eparateness is a component part of SPE, such that maintaining SPE status requires abiding by the separateness covenants. This interpretation accepts that "single purpose entity" and "separateness" are two different concepts, but recognizes that they are intertwined, making the singular heading "Single Purpose Entity/Separateness" in the mortgage both logical and unambiguous.

After the legal heavy lifting, the court concluded that by interpreting the documents at issue together, they were sufficiently clear to make insolvency a violation of the SPE covenants:

> The note, guaranty, and mortgage all refer to Cherryland's need to maintain its SPE status. The heading, "Single Purpose Entity/Separateness" simply provides a reference point in the mortgage to where one should look for that information.
>
> Defendants and the amici argue that this interpretation is inconsistent with section 43 because it results in the heading defining and limiting the provisions of the mortgage. We disagree. If the mortgage contained provisions throughout that referenced requirements for maintaining SPE status, which provisions were interpreted as not being full recourse triggers because they did not appear in section 9, this interpretation would violate section 43 because the heading for section 9 would be limiting or defining the mortgage. That is not the case here. Rather, the loan documents all reference the need to maintain "single purpose entity" status as provided in the mortgage, rendering it necessary to look at the mortgage and see what it requires. The logical and reasonable approach is to find references in the mortgage to the term "single purpose entity." So long as each reference to the term contained in the mortgage is considered, section 43 is not violated. Here, the *only* reference is the heading. Therefore, it is natural and logical to conclude that *all* of section 9, but also that *only* section 9, are the terms necessary to maintain SPE status.

Thus, the Court of Appeals held that once SPE status was lost, so was the non-recourse nature of the loan.

Court finds support in other decisions

The court candidly acknowledged its opinion was the first to hold that borrower insolvency violated an SPE covenant and gave rise to recourse liability, but defended its opinion by citing to "federal caselaw from Louisiana and Massachusetts," and finding its ruling "is consistent with a 2001 trial court ruling out of Wayne County," which cases it then evaluated at length in support of its opinion.[ii] Having thus supported its legal analysis, the court acknowledged its ruling could have a devastating impact on Michigan's troubled business borrowers:

> We recognize that our interpretation seems incongruent with the perceived nature of a nonrecourse debt and are cognizant of the amici's arguments and calculations that, if accurate, indicate economic disaster for the business community in Michigan if this Court upholds the trial court's interpretation. Nevertheless, the documents at issue appear to be fairly standardized nationwide, and defendants elected to take that risk—as did many other businesses in Michigan and nationwide. It is not the job of this Court to save litigants from their bad bargains or their failure to read and understand the terms of a contract….

Lessons learned

There are lessons for both lenders and borrowers in this opinion. For lenders, to review loan package forms to assess whether SPE is properly defined, and to assure these forms require that to maintain SPE status (and avoid recourse) the principal borrower must remain solvent. The court found the loan package in this case to be typical, but also noted some of the documents reviewed in comparable cases were more clearly written.

For borrowers and guarantors, it is critical to negotiate up front the exclusion of solvency or adequacy of capital as a recourse trigger. Otherwise, even in the absence of "bad acts" such as fraud, market conditions causing borrower insolvency will give rise to recourse liability, which is plainly the opposite of what the borrower thought it bargained for in a non-recourse loan.

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[i] The court appears to have quoted extensively from the Amended brief of amici curiae filed in *In re Gen Growth Props, Inc*, 409 BR 43 (SD NY, 2009), pp 4–14.

[ii] Here, there was no dispute as to Cherryland's insolvency, though the court rejected the defendants' argument that insolvency caused by market conditions did not violate the covenant.

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