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Nonrecourse Carveouts: How Far is Far Enough?

Commercial Real Estate Lending:
From Ratios to the Option-Pricing Model

A Mortgage is Almost Always Preferable
to Paying Cash

Dealing with Approval Contingencies
in Agreements of Sale

The Lodging Property Index

Improved Hotel Market Forecasts

Catalog Store Use and Exclusive Clauses: Part I

Net Leases as Real Estate Investments

The Shopping Center Percentage Lease: Part 2

Prorating Real Estate Taxes at Closing
of Sale of Shopping Center Property

Tax Rules Punish Victims
of Mortgage Foreclosures

Underwriting Residential Properties Today:
A Primer

Using "Average Occupancy"
to Compute Landlord's Cost Recovery

Point of View

People and Property

Law and Taxation

Executive Compensation

Warren,
Gorham &
Lamont

NONRECOURSE CARVEOUTS: HOW FAR IS FAR ENOUGH?

A tool to reduce lenders' risks can reduce their competitiveness.

JOSHUA STEIN

In the mid-1980s, borrowers escaped personal liability for almost every obligation they undertook in documents for "nonrecourse" loans. Borrowers who defaulted might lose their property, but they normally faced no further exposure. Learning from sad experience, nonrecourse mortgage lenders now insist that borrowers assume personal liability for a wide range of risks and obligations under the loan documents.[1]

Nonrecourse "carveouts" have therefore blossomed into long lists of obligations for which borrowers face personal liability. These lists often go on for pages. It sometimes seems that borrowers have personal liability (meaning that they place at risk assets other than the project) for every possible default, risk, or problem other than failure to pay principal and interest on the note.

Have lenders gone too far? If so, which of the nonrecourse carveouts should lenders abandon? On what principled basis can a lender shift back to a more borrower-friendly approach? How can lenders who believe that extensive carveouts are appropriate make sure those carveouts work? In the extensive negotiations for commercial mortgage loans, these questions often shape the most important battles.

In principle, lenders are willing to give nonrecourse protection to mortgage borrowers because they are so comfortable with the collateral that they are willing to look to it as their sole recompense if the borrower defaults. Their comfort level is so high that they waive any right to look to any other asset either for payment of the loan or for performance of other obligations under the loan documents.

A nonrecourse loan is functionally a two-step sale of an asset. Today, the lender (buyer) pays an attractive price for the asset to the seller (borrower). Tomorrow, when the loan matures, the borrower (seller) will either return the purchase money or peacefully deliver the asset sold. It is the borrower's choice. With proper loan underwriting, the transaction works for both borrower and lender. It allocates risks in a way that both parties find attractive, even though the lender bears the full risk that the value of the asset will drop below the loan amount. Nonrecourse is still the marketplace standard for long-term financing of income-producing commercial real estate.

Even before the real estate depression of the early 1990s, however, nonrecourse lenders knew that they wanted to be able to sue the borrower and its partners for certain egregious problems—such as fraud, waste, environmental issues, and misapplication of insurance proceeds, condemnation awards, and secu-

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rity deposits. The early 1990s taught lenders that they should also try to make borrowers personally liable for a multitude of other problems that often accompanied loan defaults: misuse of rental income, failure to pay taxes, failure to maintain, and a range of other actions that impaired the value of the collateral and the lender's position. Lenders also found that they could use the threat of personal liability as a hammer to convince borrowers to cooperate with and not defend foreclosure actions, or to stay out of bankruptcy.

So today's nonrecourse clauses are longer than they used to be. Because they include so many carveouts, they give borrowers less protection than nonrecourse clauses of yesterday. From a lender's perspective, they merely set the right limits to a borrower's nonrecourse protection and give the borrower and its principals healthy and constructive incentives to cooperate.

In making a nonrecourse loan, the lender estimates the value of the collateral, then decides what percentage of that value it is willing to lend. Market pressures force the lender to make that maximum loan. The lender does not want, however, to look to the asset alone for protection from risks or exposures that might upset the fundamental assumptions that justified that particular loan amount. The lender will insist on personal liability for those risks and exposures, which can be roughly broken down into the following five categories, some of which blur into one another. Collectively these categories explain all nonrecourse carveouts in common use today.

- Erosion of collateral
- Destruction of collateral
- Allocation of external risks
- Preventing additional investment by the lender
- Behavior control

Erosion of Collateral. Some nonrecourse carveouts protect a lender against borrower actions that over time erode the value and benefits that the lender reasonably expected to receive from the collateral. By making the borrower personally liable for actions or omissions like improper application of property cash flow or failure to apply rental income to debt service, the lender protects itself from gradual loss of the collateral and preserves the loan-to-value ratio under which it agreed to make the loan.

Destruction of Collateral. Other carveouts protect a lender against sudden loss or substantial impairment of the lender's collateral—one-time borrower actions that permanently diminish or destroy the expected value of the lender's collateral. Some examples: "waste," bad-faith cancellation of a desirable lease, loss of insurance followed by a fire, or surrender of an underlying ground lease. Again, the fact that the borrower is personally liable for these events helps the lender preserve its collateral and its loan-to-value assumptions.

Allocation of External Risks. A few carveouts merely shift major external risks away from the lender. For example, if a previously unknown environmental problem destroys the value of the lender's collateral, a nonrecourse carveout shifts this problem to the borrower (or its principals), protecting the lender from unexpected loss of value and deterioration of the loan-to-value ratio. Given the number of lenders that want to identify and shift to someone else all risks except nonpayment and market decline in value of collateral, one should expect to see an increase in carveouts of this type. Indeed, every time a grand new legislative scheme creates a new external risk to real estate collateral, some lenders expand their nonrecourse carveouts to shift that risk from the collateral to the borrower personally. As one recent example, some lenders have added to their litany of carveouts any risk arising from asset forfeiture because of illegal activities at the property, regardless of whether the borrower is at fault. Before that, there was the Americans with Disabilities Act.

Avoiding the Need For Additional Investment. When a lender makes a loan, the lender has typically already advanced the maximum amount it wants to lend against the collateral. The lender does not want to invest additional money merely to preserve and enforce its position. Any additional investment undercuts the lender's fundamental loan-to-value assumptions. Hence the lender will seek to make the borrower personally liable for any funds the lender must advance to protect its position. Some examples: payments for taxes or for insurance premiums; other costs incurred to protect the collateral; and attorneys' fees in enforcement.

Behavior Control. The final major category of nonrecourse carveouts reflects the desires of lenders to simplify, streamline, and speed up enforcement after a loan default. Borrowers can drag out this process through vigorous defenses and aggressive use of bankruptcy. During that time, the collateral usually deteriorates and declines in value, and unpaid interest accrues. A lender can mitigate that result by insisting that the borrower (or its principals) assume personal liability for the lender's enforcement costs, and potentially even for the entire loan, if the borrower does not surrender quickly to the enforcement process.

LIMITS TO CARVEOUTS?

Carried to their logical conclusion, these justifications for carveouts require that vast numbers of obligations under the loan documents be backed by the borrower's personal liability. Indeed, nonrecourse carveouts in modern loan documents often capture almost every meaningful obligation under the loan, except the obligation to pay principal and interest. The carveouts can become so extensive that the exceptions consume the rule.

Exhibit 1, "Carveouts from A to Z," summarizes several dozen nonrecourse carveouts that commonly appear in modern mortgage loan documents. Although few, if any, loan documents contain all the listed carveouts, many contain a substantial subset.

Carveouts have become so extensive that the obligations and risks under the loan documents that still consistently qualify for pure "nonrecourse" treatment are small in number and mostly quite minor. They are listed in Exhibit 2.

Nonrecourse lenders still agree to bear some property-related external risks that affect collateral value. Examples include the risk of loss of tenants (beyond the borrower's control), the risk of real estate depression, the risk of neighborhood decline, and similar market risks. Of course, unless lenders continued to take risks like these, nothing at all would be left to the concept of nonrecourse.

THE NONRECOURSE "CORRECTION OF ERRORS" COVENANT

Strangely, most borrowers still receive nonrecourse protection for one potentially critical obligation under the loan documents: the borrower's obligation to correct any gaps, mistakes, or defects in the lender's security package. Typically neither borrower nor lender focuses much on the "further assurances" or "correction of errors" covenant. In the worst case, however, a defect in the loan documents could cost the lender a significant portion of its collateral.

Assume, for example, that the unrecorded loan agreement for an office complex on eleven separate parcels indicates that the parties intended to include the parking lot parcel in the lender's collateral. For some reason, that parcel fell out of the legal description of the collateral attached to the mortgage. This would make the lender's claim to the parking area unperfected and worthless in bankruptcy—great leverage for the borrower and its unsecured creditors.

If the lender relied on the "further assurances" clause in the loan agreement to require the borrower to correct this error before bankruptcy, but the borrower refused, or had already mortgaged the same parking lot to the next lender, the first lender could certainly try to foreclose on the eleven parcels that were correctly subject to the mortgage. The lender would nevertheless have lost the fundamental benefit of the full security package, and it might not even be able to operate the office buildings. The lender should instead have demanded recourse against assets beyond the property to back the borrower's obligation to correct defects in the loan documents.

If this problem ever arose, the lender would probably rely on its title insurance or its attorneys' malpractice insurance. Nevertheless, lenders that are updating their nonrecourse carveouts might want to seek recourse beyond their collateral for the borrower's promise to repair defects in the security package—perhaps the best possible example of a covenant that should be carved out from nonrecourse treatment but rarely is.

REDUCING THE NUMBER OF CARVEOUTS

Although they offer protections, carveouts have both market costs and administrative costs. A lender revisiting its carveout structure might ask itself whether it really needs all these protections.

A borrower trying to limit carveouts, or the borrower's internal advocate within the lender's organization, a "sales"-oriented loan officer who is trying

EXHIBIT 1 CARVEOUTS FROM "A" TO "Z"

Bold-face indicates traditional carveouts that virtually always appear in loan documents, even from pre-1990 transactions.

Regular type indicates standard carveouts that normally appear today.

Italics indicates cutting-edge, new, unusual, or uncommon carveouts.

(1) Carveout Trigger or Obligation	(2) Basis and Nature of Lender's Loss	(3) Appropriate Extent of Personal Liability	(4) Alternative Protection Techniques That Could Substitute for the Carveout
Additional borrowings, even if unsecured	Potential complexity in bankruptcy	All loan obligations	
Any act or omission that reduces value	Erosion or destruction of collateral	Pay for loss suffered	
Bankruptcy	Sudden erosion of collateral and extra costs	All loan obligations	Bankruptcy remote entities
Books and records after foreclosure	Sudden erosion of collateral, but limited total exposure	All loan obligations? Deficiency?	Extensive reporting before default
Brokerage commissions (on loan)	Unexpected risks to lender	Commission not paid	Pay at closing or don't close
Cash on hand at time of default	Expected erosion of collateral	Amount of cash	Lockbox
Closing costs, commitment fee	Unintended additional investment by lender	Pay costs	Pay at closing or don't close
Closing certificates and affidavits	Fraud	Indemnify for loss suffered	Due diligence
Compliance with law	Erosion of collateral; additional lender investment	Cost to cure	Due diligence; reserves
Construction obligations	Unexpected risks; loss of collateral	Cost to complete less loan funds remaining	Completion guaranty
Criminal acts	Fundamental alteration of risks	Pay for loss sustained? All loan obligations?	Careful choice of borrower
Distributions in violation of loan documents	Unclear, assuming true nonrecourse[1]	Restore amount distributed (but why?). Real test may be rent diversion	Lockbox, receiver
Enforcement costs	Gradual, but open-ended additional investment by lender	Pay all costs	Strong documents, quick courts
Enforcement, contest of (defenses, etc.)	Erosion of collateral, additional cash investment by lender (deterioration of collateral during battle)	All loan obligations	Quick courts
Environmental	Sudden destruction of collateral, perhaps total	All loan obligations, all environmental. Losses. (Borrower would limit to clean-up costs)	Due diligence
ERISA violations	Problems, issues, uncertainty	All loan obligations	Due diligence
Forfeiture via government seizure (drugs, RICO, etc.)	Sudden loss of collateral, probably total	All loan obligations	Due diligence on borrower, background investigations
Fraud or misrepresentation	Sudden unexpected risk or loss of collateral	Indemnify for loss suffered?	Thorough due diligence
Ground lease default	Sudden destruction of collateral	All loan obligations	Leasehold mortgagee protections or lease and sublease

EXHIBIT 1 (cont.)

(1) Carveout Trigger or Obligation	(2) Basis and Nature of Lender's Loss	(3) Appropriate Extent of Personal Liability	(4) Alternative Protection Techniques That Could Substitute for the Carveout
Indemnity, general	Sudden alteration of risks	Indemnity for loss suffered	Enforce "additional insured" requirement; buy lender's insurance
Insurance premium nonpayment	Zero as long as no fire	Premiums not paid.	Insist on notice of cancellation (ACORD 27); monitor renewals
Interference with assignment of rents	Erosion of collateral	All loan obligations? Lost rents?	Appoint receiver
Invalidation of loan payments as, e.g., Preference	Unexpected exposure to lender	Amount of payment set aside	Conservative underwriting
Lease amendment, bad faith (rent reduction)	Sudden but permanent erosion of collateral	Personal liability for lost value of lease?	SNDA or tenant notices
Leases, violation of guidelines	Sudden but long-term erosion of collateral	Value lost because of bad lease	Recording laws?
Leases, noncompliance with	Erosion of collateral	Offsets and claims; value of lost lease	SNDA (some protection)
Letter of credit renewals	Sudden partial loss of collateral	Amount of L/C not renewed	Draw before expiry
Liens, any prohibited	Erosion of collateral; additional lender investment	Remove lien	Title claim if prior, foreclosure if not
Loss proceeds misapplication	Sudden destruction of collateral	Restore stolen proceeds	Enforce "loss payee" requirements
Mechanics' liens	Unexpected additional risk –indirect, particularly if subordinate	Indemnity for lien	Careful compliance with favorable statutes, if any (e.g., N.Y. Lien law)
Operating expenses nonpayment	Gradual erosion of collateral	Expenses not paid (perhaps limit to rents diverted)	Lockbox, receiver
Partnership with lender, claim of	Unexpected risks, potential loss of collateral	All loan obligations	Careful closing and administration of loan
Personal property removal	Sudden erosion of collateral, but limited scope	Personal property taken	No loan value for personal property
Preservation and maintenance of collateral, general	Destruction or erosion of collateral	Impairment of collateral	Aggressive monitoring, but cannot catch all problems
Rent misapplication (general or after notice of default)	Gradual erosion of collateral	Rents misapplied	Lockbox, receiver
Rent prepayment	Sudden erosion of collateral	Disgorge prepaid rent	SNDA or tenant notices
Repairs, failure to make	Erosion of collateral	Cost of repairs not made	Careful administration, frequent inspections
Security deposits diversion	Sudden erosion of collateral, but limited dollar exposure	Restore stolen deposits	Hold the security deposits
Single purpose entity violations	Greater risk of issues in bankruptcy	All loan obligations?	
Taxes, nonpayment	Gradual erosion of collateral	Taxes not paid (limited to amount of rents?)	Escrows, reporting service, lockbox, receiver
Tortious conduct, generally	Unexpected risks; destruction or erosion of collateral	Damage suffered	Lender's separate insurance

EXHIBIT 1 (cont.)

(1) Carveout Trigger or Obligation	(2) Basis and Nature of Lender's Loss	(3) Appropriate Extent of Personal Liability	(4) Alternative Protection Techniques That Could Substitute for the Carveout
Transfer or encumbrance	Sudden unexpected risks (a bad new borrower)	All loan obligations (overcompensation for incremental risk?)	Foreclosure (why is this not an adequate remedy?)
Transfer taxes on foreclosure (payment, cooperation)	Additional investment by lender	Taxes due	Escrow at closing or reduce loan-to-value
Uninsurable loss	Sudden destruction of collateral	Amount of casualty loss	
Uninsured loss, but insurable	Sudden destruction of collateral	Amount of casualty loss	Careful insurance admin.; Escrows; single-interest coverage
Waste	Sudden destruction or erosion of collateral	Pay costs to repair	Careful choice of borrower
Yield maintenance premium	Additional investment by lender, unexpected risk	Amount of premium	Lower loan-to-value

to preserve the lender's competitiveness in the marketplace, might make the following argument in response to the limitless expansion of nonrecourse carveouts.

The lender's initial loan-to-value analysis is purely a device to calculate the initial loan amount. The borrower's "equity cushion" is designed precisely to leave room for eventualities like the accrual of interest after default, lender's costs and expenses of enforcement, possible borrower diversion of rents, and other losses and delays that accompany loan default. Lenders know these things will happen; that is why they lend less than the full value of the collateral.

This argument may have some merit as to nonrecourse carveouts that relate to "nonculpable" conduct that merely erodes the lender's collateral over time. It is, however, difficult for a borrower to point to the "equity cushion" as a reasonable way for a lender to protect itself from risks—or, worse, intentional bad acts—that can produce more extensive and sudden damage to the lender's loan-to-value position.

Cutting back the carveouts is not easy. Every carveout can be readily justified. A conservative lender has good reason to want more support than the collateral alone provides, for every risk addressed by a carveout and even many that are not (yet). On a risk-by-risk basis, every well-crafted carveout comforts the lender regarding some potential nightmare. Lenders that start to think about carveouts may end up asking not how to cut back, but instead whether they should insist on personal liability even for the short list of minor obligations for which most lenders normally still accept nonrecourse treatment.

If a lender wants to reduce the number of carveouts, that lender might ask whether the risk addressed by a carveout can be mitigated by a mechanism other than personal liability. For example, if the lender's concern is rent diversion, then the lender could insist on a lockbox. If the lender is concerned about bankruptcy, it can ask the borrower to form a "bankruptcy-remote" entity. If the lender is concerned about theft of security deposits, it can hold the security deposits.

Column 4 of Exhibit 1 suggests devices other than nonrecourse carveouts that a lender might employ to mitigate the risk that motivated each carveout. Both borrower and lender, however, must be willing to live with these devices, which are not always smooth and easy to administer.

Once a lender decides that a particular risk requires personal liability because the collateral does not provide enough protection and substitute protections do not make sense, the lender must ask three important questions:

- Who will be personally liable?
- When will that liability arise?
- How much personal liability?

EXHIBIT 2 What's Left of Nonrecourse?

A. Payment
1. Principal
2. Interest
3. Prepayment premium (usually but not always)
4. Late charges
5. Deposits in escrows or reserves (but personal liability for failure to pay underlying costs—occasionally even personal liability for deposits)
6. Taxes imposed on the transaction (mortgage tax, adverse changes in taxation)
7. Participation payments (percentage of net cash flow or gain on disposition)
8. Leasing commissions
9. "Rent" for occupancy after foreclosure (functionally interest on loan)

B. Reporting, Deliveries, and Information
1. Cooperation with lender audits and inspections
2. Further assurances (including even correction of defects in the loan security package)
3. Budgets
4. Financial reporting (other than delivery of books and records after foreclosure) (occasional personal liability for entire loan as "behavior control")
5. Future environmental updates (personal liability for clean-up and environmental indemnity, though)
6. Estoppels by borrower or tenants
7. Other information requested by lender
8. Notice to lender of bad events
9. Financing statements, additional

C. Miscellaneous Covenants and Defaults
1. Change in management
2. Borrower not to liquidate, dissolve, etc.
3. Breach of representation or warranty (unless fraudulent)
4. Operating covenants (e.g., "operate as a first-class office building") beyond (a) compliance with law and (b) payment of specified expenses
5. Transactions with affiliates (not rising to fraud or diversion of rental income)
6. Maintenance of beneficial easements (unless deemed general preservation of collateral)
7. Replacement of worn-out or obsolete equipment (as opposed to equipment removed or stolen)

D. Extrinsic Risks Related to the Collateral (Underwriting Mistakes or Surprises)
1. Real estate recession, local or national
2. Loss of tenants (bankruptcy, lease nonrenewal, etc.)
3. Neighborhood decline
4. Technological obsolescence

Identifying Who Will Be Personally Liable

If the borrower is a typical single-asset real estate entity, then personal liability of the borrower does not give a lender anything that the lender does not already have. Because the single-asset borrower has no assets beyond the one asset that the lender has already encumbered to secure all obligations under the loan documents, access to the borrower's other assets (personal liability) means little or nothing.[2] The process of negotiating the personal liability of the borrower in these cases might not even be worth its legal fees.

Because of this problem, lenders have for some time insisted on obtaining personal indemnities from the borrowers' ultimate principals for environmental risks. More recently, some lenders insist that the borrowers' principals provide various forms of limited personal guaranty—such as "springing" or "exploding" guaranties—to provide access to additional assets to back many other nonrecourse carveouts.[3] Only to the extent that they are accompanied by such guaranties do nonrecourse carveouts give the lender meaningful protection against risks for which the lender does not want to rely solely on the collateral.

As a procedural alternative to guaranties, some lenders ask the borrower's principals to join in the loan documents personally, making them primary parties, not merely guarantors. The principals' liability may terminate (except as to

environmental risks) when the borrower repays the loan or peacefully surrenders the collateral. This requires less paper than separate guaranties and may create a more direct route to liability.

If the principals who assume personal liability for nonrecourse carveouts also have passive investors in their borrowing entity (e.g., limited partners), the lender needs to consider some additional issues. After a default, the principals might be reluctant to hand over the keys if such a surrender might lead their investors to claim "breach of fiduciary obligation" against the principals. The investors might argue that the principals acceded to the lender's demands only to avoid personal liability under the guaranties—a claim that the lender certainly hopes will be correct, as this was why the lender demanded personal liability.

After default, it can be assumed that not only would the limited partners not be inclined to consent to conveyance of the collateral to the lender in lieu of foreclosure, they would also probably threaten to sue if the general partners made any such conveyance. Even if this threat were merely a negotiating technique, it could impede an orderly surrender of the collateral after default, and hence destroy or delay the benefits that the lender expected from the personal guaranties.

Because the limited partners, as innocent victims of a breach of fiduciary duty, might be able to assert claims for punitive damages, their threats against the principals might substantially outweigh whatever threats the lender might assert.

A lender can solve this problem by insisting that, at the time of the loan closing, the limited partners consent to a conveyance of the collateral to the lender, even if the conveyance releases the principals' personal liability. That consent would appear both in the limited partnership agreement and in a separate closing document. It would contain all the appropriate disclaimers and disclosures to prevent future arguments by the "victimized" limited partners.

While access to the balance sheets of the borrower's principals can give the lender claims against assets beyond the collateral, the lender needs to ask a few questions about those balance sheets. To the extent that the lender actually intends to look to the principals for credit enhancement to compensate for risks in the transaction, as opposed to merely using the guaranties as a club to hold over the principals' heads, the guarantors must be creditworthy. In a real estate depression, however, the balance sheets of real estate people often suffer. In such circumstances, the lender may revert to relying on the property alone—which puts the lender back where they were before they started carving out the nonrecourse protections.

Amount and Timing of Liability

In structuring nonrecourse carveouts, a lender needs to think about how much personal liability should be created and when— issues that nonrecourse carveouts rarely address, giving a principal who faces personal liability a blank canvas on which to paint creative arguments for why he has no liability, or at least not as much liability as the lender thought.

Guarantors can argue, for example, that the lender did not suffer any loss until it foreclosed on the collateral and resold it at a loss. They can argue that the loss was caused by something other than the carved-out risks. They can argue that the loss was the lender's fault, or was overstated, or was only temporary and was compensated for by something else. And they can argue that the lender should have proceeded against the borrower first. To solve or reduce these timing problems, a lender can insist that carveout mechanisms allow the lender to assert a clearly defined claim as early as possible, against both the borrower and the guarantors.

For example, if the lender wants to obtain personal liability for "diverted rents," it might require that if the borrower diverts rents, the lender can require both borrower and guarantor to pay down the loan immediately by an amount equal to the diverted rents (plus the normal prepayment premium). If the lender believed this formula did not sufficiently discourage the borrower from diverting of rents, it might require the borrower to amortize the loan by some multiple of the amount of diverted rent. If the borrower failed to make this amortization payment, the lender would have an immediate claim directly against the guarantor for the same amount.[4]

This approach could apply to any imposition of personal liability where the borrower commits particular bad acts. A lender may want its loan documents to specify how that liability is calculated and require immediate payment, perhaps as mandatory amortization of the loan. A lender might also want to require that if the borrower commits certain particularly egregious acts, the guarantor would become personally obligated to repay the entire loan immediately.

Fine-Tuning the Personal Liability Claim

Without a mechanism to readily define and quickly enforce personal liability, a nonrecourse carveout merely leaves the lender with an undefined claim against someone. This is better than nothing, but it is only the beginning of a long and complicated argument before a judge. The more specific the claim, the greater the lender's leverage if a carved-out risk should actually hit.

Borrowers and their principals and counsel can also play the fine-tuning game. Borrowers and their principals can try to trim back their personal liability—creating additional complexity that will inevitably slow down enforcement if the loan ever goes bad.[5]

For example, a borrower might seek to specify what it means to use rental income for purposes unrelated to the property. Partnership distributions are obvious diversions, but what about money paid to affiliates for services rendered? Does the lender want to try to determine whether expenditures were excessive and wasteful? Should the lender get involved in approving expenses? Does it really want to review years of property records to determine how much cash was "available" to pay property-related expenses? Left to their own devices, counsel to borrower and lender might set up structures in which, for example, the lender periodically reviews the application of cash flow and confirms that no rental income has been diverted. Rather than venture into this territory, loan documents usually leave "diversion" to be defined later. And borrowers often negotiate that personal liability for diversion begins only after they receive notice of default.

MORE BORROWER ARGUMENTS AGAINST CARVEOUTS

Borrowers might argue that some of the common carveouts relate to risks that cause the lender no significant damage. Thus, if the borrower transfers the property in violation of, but subject to, the mortgage, the lender still has all the same rights under the mortgage.[6] Or, if the borrower borrows other money on an unsecured or subordinate secured basis, the lender (arguably) suffers no injury other than a hypothetical and manageable level of additional complexity in a borrower bankruptcy. This problem is not serious enough to justify personal liability, the borrower would argue. The same argument applies if the borrower fails to pay any category of operating costs that cannot give rise to a lien.

The marketplace and the lender's competitors are the strongest argument against extensive carveouts. But lenders that agree to accept greater risks because of competition run the risk of entering a race to the bottom much like the competition that led construction lenders in 1988 to fund 105 percent of appraised value (as completed).

If a borrower does not intend to commit any "bad acts" that might trigger personal liability under nonrecourse carveouts, it is difficult to see why that borrower would regard most carveouts as a burden or an implied extra cost. Moreover, in theory at least, a lender that obtains extensive carveouts should be willing to lend a higher percentage of value on more favorable terms than would a lender that must rely on the collateral alone for more risks.

So the "good faith" borrower, particularly one with principals whose balance sheets are strong and who are willing to back the borrower's personal liability with their own, should find the best deal from the lender with the most extensive carveouts. Whether the marketplace actually works that way may be the topic for a future article.

ENDNOTES

1. See J. Stein, "Mortgage Loan Structures for the 1990s," 24 *Real Est. Rev.* (Spring, 1994); "Nonrecourse Clauses Revisited," 22 *Real Est. Rev.*, (Summer, 1992).

2. Of course, if the borrower is a partnership with a general partner that has significant assets, the lender would obtain access to those assets. More typically, however, the general partner is a single-asset corporation or limited liability company. In each case, the borrower entity has no power to bind its ultimate principals or to make them personally liable for anything—no matter what the loan documents say. Even if the principals or a "president" of a corporation actually sign the loan documents, those signatures are on behalf of the borrowing entity, not in the signers' individual capacities. The individuals are simply not parties to the documents and cannot be bound by them.Of course, if their actions were tortious without regard to the loan documents, the lender's claims would arise independent of the loan documents, but not necessarily be easy to assert and win.

3. The former guaranties will "spring" into existence in the event of a bankruptcy or a contested foreclosure. Some lenders prefer "exploding" or "defeasible" guaranties, which go into effect at the closing and stay in place until the borrower pays the loan or conveys the collateral, in satisfactory condition (both physically and financially), to the lender. These guarantees are more definitive, and less conditional, than the springing guarantees.

4. A guarantor might argue that the structure constitutes a "penalty" and an unenforceable burden on the borrower's constitutional right to file bankruptcy. It is not at all obvious that this argument would succeed. At least one recent New York case supported the proposition that a nonrecourse borrower's bankruptcy could trigger personal liability of the borrower's principals for the entire loan. First Nationwide Bank v. Brookhaven Realty Assoc., 637 NY Supp. 2d 418 (NY App. Div. 1996).

5. Given the importance of the nonrecourse clause and its carveouts, many lenders short-circuit negotiations by attaching to their commitment letter or application the exact language that the loan documents will contain on these topics.

6. The lender can argue that the new owner of the property may be less cooperative and more "difficult" than the transferor, thus increasing the lender's expected costs and delay of loan enforcement. The strength of this argument depends on circumstances. Even the nicest borrower can turn nasty after a default.