Forcing the hand of a participant in default.

Nonrecourse Clauses Revisited

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WHEN A NONRECOURSE REAL ESTATE transaction runs into trouble, the defaulting party often holds all the cards. That party can control the situation and extract new concessions that neither party contemplated when it entered into the original transaction.

This is one of the many lessons that have emerged from the wreckage of the real estate boom of the 1980s, a decade when nonrecourse clauses were an automatic part of many transactions. Although the lesson comes too late for transac-

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tions already closed, parties renegotiating or restructuring a 1980s' nonrecourse transaction can put the lesson to use when they try to clean up the mess and restructure the transaction.

The theory behind a nonrecourse clause or transaction structure is simple and reasonable. A developer puts certain assets at risk when he undertakes a project. If the project fails, that party will not be legally obligated to invest more money. If he chooses, he can walk away with impunity. Although he has lost his original investment, he has no personal liability and his other assets are not at risk. Other participants bear the downside risks of the project in exchange for benefits that make their liability worthwhile.

As part of a negotiated nonrecourse package, the lender, landlord or other partners (depending on the transaction) assume and expect that the limited remedies they retain, such as foreclosure, will protect them in the event of a default. It often doesn't work that way.

INTERMINABLE LITIGATION

Instead of accepting the negotiated remedies and walking away when the deal goes bad, the defaulting party can and often does throw the whole transaction into interminable litigation and bankruptcy proceedings, running up costs that are disproportionate to the original transaction and dragging out the process for months or years.

The limited remedies that were supposed to be available to the lender, landlord, or other partners become worthless. Perversely, the party in default often gains total control of the situation—either occupying the property without paying rent or debt service, or remaining a partner of the partnership with the possibility of future upside without performing its obligations under the partnership agreement. Sometimes the party in default can successfully demand to be paid off in exchange for walking away from the project.

Parties who structure or restructure a nonrecourse transaction today, whether a loan, a lease, or a partnership, can prevent the unintended consequences of a default. In exchange for limiting the defaulting party's liability, they should demand assurances that the nonrecourse remedies they retain will be useful and will force the defaulting party to quickly decide either to perform or to abandon the project.

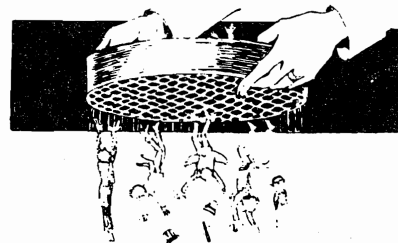
The principal defect of the nonrecourse documentation of the 1980s was that it did not consider the practical problems of trying to enforce remedies after default. Lenders, landlords, and partners rarely stopped to consider how nonrecourse concepts work in a judicial environment in which a defaulting party (even one with no risk of personal exposure) can use litigation to gain years of delay in the enforcement of remedies, free from additional expenditures (other than attorneys' fees).

Limitless litigation creates limitless expenses and delays for the parties who are not in default. It destroys the justifications for the nonrecourse clause. For example, the passage of time and accrual of interest destroys the "equity cushion" that a lender relies on to prevent losses. Moreover, the property subject to foreclosure often deteriorates during protracted litigation.

The solution to the problem varies with the transaction. Examples of possible mechanisms follow.

LIMITED GUARANTEES IN NONRECOURSE LOANS

A lender negotiating or restructuring a mortgage loan may still agree to limit its remedies to a foreclosure and to waive any personal judgment against the borrower, but it should insist on having guarantees to protect against delays in exercising its remedies. These guarantees could eliminate or at least reduce the risk that the lender may be stuck for years without either the collateral or a performing loan or a solvent borrower.



The loan documents should provide that the nonrecourse clause would remain effective only if, after a default, the borrower deeded over the collateral to the lender, or cooperated in a consensual foreclosure, within a given period after the lender's request.

The limitation on nonrecourse protection should include a back-up guarantee from the borrower's principal. If the defaulting borrower refused to cooperate with the foreclosure, or tried to seek judicial refuge (such as bankruptcy or lender liability claims), the lender could demand that the borrower's principal repay the entire loan or at least interest and foreclosure costs.

As an alternative, the principal's guarantee of

the entire loan could remain in force from the first day of default, but could terminate if the borrower delivers a deed in lieu of foreclosure and moves out.

Either mechanism might protect the lender from carrying costs and deterioration of the property during years of judicial delay while the lender tried to foreclose.

If the borrower lives up to the original quid pro quo—limited liability in exchange for risk of quick loss of equity—and cooperates with the lender's foreclosure, the guarantee would never activate. If, however, the borrower vigorously defends or delays the process, or files bankruptcy, the lender would have access to the borrower's principal.

Because guarantees are sometimes vitiated by a morass of enforcement problems, the lender might (in some states) be able to require that, rather than offer a personal guarantee, the borrower's principal agree unconditionally to purchase the loan if the following two conditions exist: the loan goes into default and the borrower tries to block the lender from exercising its limited remedies.

GUARANTEES IN NONRECOURSE LEASES

Nonrecourse clauses in leases, or leases entered into with single-purpose no-asset corporations ("shell tenants"), create similar problems. A clever tenant can drag out eviction proceedings for months or years, retaining possession yet paying no rent. Delays during court proceedings, including those caused by declarations of bankruptcy, not only deprive the landlord of possession, but also cut off rental income and the prospect of collecting past-due rent (beyond the security deposit) from the tenant.

To solve this problem, the landlord should insist that a creditworthy principal of the corporate tenant guarantee payment of (1) all rent due under the lease from the date of default until the tenant actually moves out, (2) interest on the amount during the the default, and (3) the landlord's attorneys' fees. If eviction proceedings drag on more than, say, two months, the tenant's principal could become personally liable for all obligations under the lease. In addition, the landlord should obtain personal assurances that the tenant will not damage the space before leaving or fail to pay contractors.

A guarantee of this type would eliminate the tenant's incentive to drag out eviction proceedings while paying no rent. It therefore would preserve the benefits of the original transaction for all parties. The tenant's principal would still enjoy nonrecourse protection as long as the tenant moved out after a default. The landlord could obtain either payment or possession.

THE DEFAULTING PARTNER

Partnership agreements among single-purpose shell corporations as partners also often use nonrecourse structures. Under these agreements, partners deliver cash or letters of credit when they enter the partnership. If the partnership later needs more capital, each partner may choose whether to make a contribution. No one can be forced to pay.

The partners who do pay have the right to squeeze out the defaulting partner or squeeze down that partner's interest in the partnership. Either remedy may be disproportionate to the default, but the nonperforming partner and its principals have no risk of any personal liability.

In negotiating or restructuring partnership agreements, the partners should insist that the principals of each partner offer complete guarantees that they will cover the proportionate shares of any capital call, with a proviso that the partnership may not make claims against the defaulting partner (or its guarantor) if the partner cooperates with a squeeze-down or other remedies in the agreement, and stays out of bankruptcy.

The partnership agreement and back-up guarantees should provide that if the defaulting partner contests the agreed-on remedies (or if a court decides they are too draconian to enforce), the other partners can reach the assets of the partner's ultimate principals, notwithstanding the limitations of the nonrecourse clause. A principal's guarantee also could be expressed as a buyout obligation triggered by the partner's bankruptcy or other adverse event.

CONCLUSION

Each of these structures recognizes and preserves the nonrecourse structure yet gives the defaulting party and its principals an option. They can have the benefits of nonrecourse clauses and live with the risk of being rapidly wiped out by a default, or they can drag out the process in exchange for facing full personal liability. But they cannot continue to have both unlimited delay and limited personal liability. (This assumes, of course, that the principals remain creditworthy and do not become mired in their own insolvency problems. It also assumes that the mechanism suggested in this article will be

honored by the courts of the particular state where the litigation occurs.)

History should teach us how to avoid the mistakes of the past. The lessons of the 1980s should be taken into account in the restructurings and renegotiations of the 1990s, so that today's negotiators can avoid the errors of the preceding decade. Every time a transaction is restructured or renegotiated, the parties should try to add new mechanisms to ensure that a party who defaults no longer has the luxury of both limited liability and unlimited delay. ■