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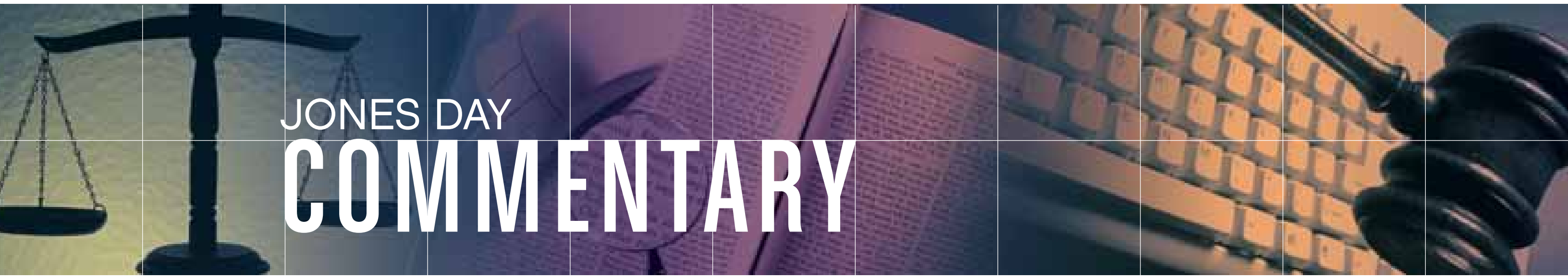

DISTRESSED TIMES CALL FOR ORDINARY MEASURES: REVISIT YOUR LOAN COVENANTS TO AVOID SPRINGING RECOURSE LIABILITY

When reduced cash flow leads to loan defaults, and negotiations with lenders do not seem to be leading toward amicable restructuring, borrowers must consider how to create leverage and perhaps defend against foreclosure and other remedial actions by lenders. In so doing, borrowers need to be cognizant of the fact that many non-recourse loans, particularly those where the borrower was required to be a single purpose entity ("SPE"), contain separate guaranties from creditworthy parents or affiliates that create liability in certain cases, including in the event that the borrower files bankruptcy. These "springing guaranties" have proven to be one of the most effective deterrents to filing bankruptcy and to other delay tactics used by owners to forestall foreclosures. Borrowers and guarantors must be certain the restructuring that is contemplated in the proposed bankruptcy proceedings generates more value than the recourse liability that arises from the springing guaranty.

While most borrowers and guarantors are well aware of the recourse liability that may arise from a bankruptcy filing, borrowers and guarantors are cautioned that other actions they may take could also trigger springing recourse liability under otherwise non-recourse property loans. When considering possible operating decisions for a distressed property, borrowers and guarantors should carefully evaluate their loan covenants to identify those that will lead to recourse liability if breached and those that will only lead to loan defaults entitling the lender to foreclose on the collateral.

Depending on the particular language of the loan documents, the scope of the springing recourse liability can be the entire principal amount of the loan plus interest, late fees, prepayment penalties, defeasance or yield maintenance costs, attorneys' fees, and other costs incurred by the lender, or may be limited to the actual damages caused by the default. The liability may also be capped.

"BAD BOY" COVENANTS

Most non-recourse loans will include a set of "springing" recourse covenants, often referred to as "bad boy" covenants, which focus on preventing the borrower from taking actions that would constitute fraud, gross negligence or willful misconduct, waste, misapplication or conversion of operating funds, or insurance or condemnation proceeds and the like. "Bad boy" covenants are often also the subject of a separate guaranty by the parent or other creditworthy affiliate of the borrower, and violation will not only create recourse to the borrower under the "springing guaranty" provisions of the loan agreement, but also liability of the guarantor under the separate guaranty.

While it goes without saying that it is important for borrowers to avoid this type of conduct, the purpose of this *Commentary* is not to caution against taking actions that in some cases might arguably be criminal in nature, but to explore conduct that might appear, on the surface, to be beneficial to the property, but that might nevertheless lead to recourse liability under what would otherwise be a non-recourse loan.

OTHER COVENANTS

Most recently closed loans require the property owner to be a single purpose entity ("SPE") and to comply with a number of bankruptcy-remote requirements in order to isolate and protect their loan collateral from unrelated obligations of the borrower's affiliates. In addition to a springing guaranty for a bankruptcy filing, many loans contain a prohibition on "willfully interfering" with the lender's pursuit of its rights and remedies under the loan documents. Since violations of these types of covenants and other covenants intended to preserve the value of the mortgaged property may not be curable defaults, such violations often will give rise to springing recourse liability under the loan and most likely will be covered by a separate guaranty, particularly when the borrower is an SPE.

Failure to understand how these covenants might be brought into play when determining how to deal with a distressed property could have an unintended and unpleasant result for borrowers and their guarantors.

CASE STUDIES

The following highlights cases that have led to springing recourse liability in situations that did not clearly violate a specific "bad boy" covenant. The first two cases illustrate the danger of borrower and guarantor actions taken with apparently good intentions, and the last two cases illustrate the danger of borrower and guarantor vigorously attempting to protect their investments.

No Good Deed Goes Unpunished. In *LaSalle Bank NA v. Mobile Hotel Properties, LLC*, 367 F. Supp. 2d 1022 (2004), borrower's and guarantor's conduct that benefited the property had the unintended consequence of giving rise to springing liability. In *LaSalle Bank NA*, the guarantor made multiple loans to the borrower in violation of the loan covenants restricting additional debt. Additionally, the borrower modified its articles of organization expanding its stated purpose. Notwithstanding the loans by the guarantor, the borrower defaulted on its monthly payment obligations to the lender. The court noted that each one of these independent violations of the loan's covenants triggered full recourse liability. As a result, even though the guarantor acted to preserve the property by making interest-free loans to the borrower and the borrower never engaged in any business activity other than the ownership and operation of the property, the guarantor nevertheless became fully and personally liable to the lender for a deficiency judgment after the foreclosure and sale of the property.

Action (or Inaction) of Others. In *Heller Financial, Inc. v. Lee*, 2002 WL 1888591 (N.D. Ill. Aug. 16, 2002), the court found that borrowers and guarantors can trigger recourse liability if adverse conditions (such as mechanics' liens) are not cured, even when the borrower or guarantor is not otherwise engaged in the management of the business or property. The court had no sympathy for the defense raised that the limited partners did not have knowledge of the liens because they had delegated the responsibility for management of the real property to a third-party management company approved by the lender.

Delaying the Inevitable. In *FDIC v. Prince George Corporation*, 58 F.3d 1041 (1995), the court enforced covenants that prohibited actions that would interfere with the lender's ability to foreclose on the collateral when a borrower defaulted under its non-recourse loan and then vigorously contested and delayed foreclosure for more than four years. When settlement negotiations failed, the borrower filed an action seeking to enjoin the lender from foreclosing on the property. When the lender defeated the borrower's injunction action, the lender commenced foreclosure proceedings. In defense, the borrower filed multiple motions in the foreclosure action, and then four days before the foreclosure sale, one of the borrower's general partners filed an involuntary bankruptcy petition, which delayed the foreclosure sale for another three months. The defensive actions taken by the borrower against the lender were found to violate the interference covenants.

In another example of the negative consequences of delaying the inevitable, in *First Nationwide Bank v. Brookhaven Realty Associates*, 223 A.D.2d 618 (1996), a borrower filed a voluntary bankruptcy petition that was not dismissed until more than 90 days after filing. By doing so, the borrower triggered the full recourse provision of the loan agreement permitting the lender to recover a deficiency judgment against the borrower, which was a general partnership, and its partners.

PRACTICAL CONSIDERATIONS

The following list of practical considerations regarding springing recourse liability is a good starting point for borrowers and guarantors:

- When considering a bankruptcy filing, make sure you understand the scope of any springing recourse guaranties that have been given by parents, affiliates, and, if the borrower is part of a joint venture relationship, your partners and/or their affiliates. If in a joint venture, pay particular attention to contribution or other back-stop provisions that would make your partner's liability your own. Consider whether the bankruptcy will generate sufficient new value to outweigh the new recourse liability.
- Review your other loan covenants carefully. Before taking any action, pay particular attention to those loan covenants that may create springing recourse liability if violated.
- Follow the SPE provisions in the loan documents, since any material deviation may create liability. Examples of SPE provisions include, but are not limited to: keeping separate accounts, maintaining required separate books and records, not commingling funds or other assets, conducting business in the borrower's name, paying liabilities and expenses only with borrower's own funds, respecting corporate formalities, maintaining arm's-length relationships with affiliates, maintaining separate stationery, invoices, and checks, and maintaining adequate capital.
- Consult with counsel before contributing or loaning funds into the borrower entity, since the form of the cash infusion may trigger a default under the loan covenants.
- Delay tactics with the lender, which are intended to forestall foreclosure, can be risky if the borrower's defenses to collection are not successful. In some instances, merely raising a defense can trigger springing liability.
- If you are a guarantor who is not in control of the borrower, stay on top of the borrower's business in order to avoid being surprised by springing liability created by the actions of others.
- Take the loan covenants seriously and do not assume that all problems can be worked out with the lender.

CONCLUSION

With careful evaluation of existing loan covenants and proposed actions intended to address negative economic conditions affecting their properties, borrowers and guarantors can avoid triggering so-called "springing" recourse liability and preserve the non-recourse protections within their original loan documents.

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