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Guarantor beware — is the loan really non-recourse?

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Most borrowers under commercial mortgage-backed securities and other typical "non-recourse" secured financing, have long assumed that, other than with respect to so called "bad boy" carve-outs, the principals who guarantee such "bad boy" carve-outs will be insulated from personal liability, as long as they do not commit fraud, waste, file bankruptcy, make improper transfers and otherwise cause the borrower to comply at all times with single purpose entity (SPE) covenants. A recent decision by the Michigan Court of Appeals in *Wells Fargo Bank N.A. v. Cherryland Mall LP et al*, calls into question that assumption and raises concerns for all guarantors of so-called "non-recourse" secured loan products.

In *Cherryland* the borrower lost its property to foreclosure, when the lender was the successful bidder and bid approximately $2.1 million less than the outstanding loan amount. The lender than initiated an action against the borrower and its non-recourse carve-out guarantor to recover the entire deficiency. The linchpin of the lender's argument was that the single purpose entity covenants in the loan documents included an express covenant that the borrower "remain solvent and ... will pay its debts and liabilities ... from its assets as they become due." The loan documents provided that a failure to comply with these covenants triggered "full recourse" liability under the related guaranty. Even though it is the case in virtually all foreclosures actions against single purpose entity borrowers, that the borrower will be insolvent post-foreclosure (and almost certainly sometime pre-foreclosure), the court ruled that the borrower violated these solvency covenants and therefore triggered "full recourse" liability for both itself and the guarantor!

The court stated: "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 form their bad bargains or their failure to read and understand the terms of a contract."

Given that virtually all commercial mortgage-backed securities and other "non-recourse" loan products contain some sort of "solvency" covenant(s) in their single purpose entity provisions, the violation of which (if interpreted as by the court in *Cherryland*) often triggers full recourse liability for borrowers and the related guarantor, savvy borrowers, guarantors and their counsel, will need to pay special attention when negotiating "carve-out guaranties." This may prove tricky in some cases, given many lenders' general stance that in the post-Great Recession financial environment, their loan documents are largely "non-negotiable." At a minimum, the ruling in *Cherryland* should change that stance - at least as to single purpose entity solvency covenants.

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