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Was That a Carve-Out Guaranty That I Signed, or a Full Guaranty?

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Many multifamily real estate loans are nonrecourse when it comes to the borrower and its principals, with the principals signing what's known as a "carve-out" guaranty. The carve-out guaranty was originally introduced into the market by lenders in order to protect the lender when the borrower and its principals committed certain enumerated bad acts.

However, over time and through the recession of the past few years, the list of bad acts in the carve-out guaranties has grown to a point where many of the carve-out guaranties that are signed today could be viewed as full guaranties of the underlying loan. In fact, that is just what the United States District Court in Michigan recently decided in *51382 Gratiot Ave. Holdings v. Chesterfield Development Co.,* Case No. 2:11-cv-12047 U.S. Dist. (D. Mich. Dec. 12, 2011). This decision challenges expectations in the real estate industry as to the extent to which guarantors may be liable under carve-out guaranties.

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When carve-out guaranties were first introduced, they were generally intended to cover truly bad acts by the borrower, such as misappropriating income from the property after a default, making material misrepresentations and committing fraud. Lenders were looking for ways to discourage borrowers from taking certain actions in bad faith prior to a foreclosure or deed in lieu of foreclosure. Over the years, for one reason or another, lenders have expanded the list of carve-outs to include a broad range of acts, such as filing for bankruptcy, failing to maintain insurance required by the loan, failing to pay taxes, failing to maintain and repair the property and, more recently, violating single-purpose entity covenants.

What used to be a "standard" carve-out guaranty is no longer standard, with each lender determining what covenants they wish to add to an ever-growing list of carve-outs to nonrecourse loans. The broadened scope of carve-out guaranties has become increasingly common in real estate transactions in recent years, and has become the target of much negotiation during loan closings. It has also become the focus of litigation, particularly as disputes resulting from the financial distress over the past few years work their way through the judiciary.

In *51382 Gratiot Ave. Holdings*, the Michigan court held that the borrower's breach of the single-purpose entity covenant, which provided that the borrower shall "not become insolvent or fail to pay its debts and liabilities from its assets as the same shall become due," triggered the guaranty and subjected the guarantor to full recourse for the deficiency between the balance owed on the loan and the value of the foreclosed property, an amount equal to $12,240,108.64.

In that case, Chesterfield Development Co. obtained a $17 million commercial mortgage loan. To secure the loan, Chesterfield mortgaged the Chesterfield Village Square shopping center in Chesterfield, Mich. The guaranty was signed by John Damico. Less than four years after entering into the loan agreement, Chesterfield stopped making payments. The lender sent Chesterfield a notice of default stating that the loan had been accelerated and demanding full payment of the loan. Chesterfield did not pay the accelerated loan balance. The lender foreclosed its mortgage and the shopping center was sold at public auction to the

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lender. The lender then filed suit against Chesterfield and Damico, personally, to recover $12,240,108.64, the deficiency between the balance owed on the loan and the value of the foreclosed property.

Under the terms of the guaranty, the court determined that Damico was personally liable for all obligations for which Chesterfield was liable. The primary point of contention was whether Chesterfield incurred full recourse liability by violating a condition contained in the mortgage. Under the promissory note, Article 11(c) designated several springing recourse obligations, the occurrence of which would trigger full recourse liability. Article 11(c) provided in pertinent part:

> Notwithstanding the foregoing, the agreement of Lender not to pursue recourse liability as set forth in subsection (a) above SHALL BECOME NULL AND VOID and shall be of no further force and effect and the Debt shall be fully recourse to Borrower in the event that… (ii) Borrower fails to comply with any provision of Section 4.2 [of the mortgage].

Under the mortgage, Section 4.2(j) provided that Chesterfield shall not "become insolvent or fail to pay its debts and liabilities from its assets as the same shall become due."

The lender argued that Chesterfield and Damico were liable for the full amount of the loan because a springing recourse event occurred — Chesterfield became insolvent and failed to pay its debts and liabilities from its assets — which triggered Chesterfield's and Damico's obligations under the terms of the loan agreement and the guaranty. In a nutshell, the lender averred that Chesterfield's failure to make payments on the loan resulted in a default under the promissory note, which violated Section 4.2(j) of the mortgage and, therefore, Chesterfield and Damico faced full recourse liability under Article 11(c)(ii) of the promissory note and were personally liable for the deficiency on the loan.

The court agreed and granted summary judgment for the lender. According to the court's two-pronged analysis of Section 4.2(j) of the mortgage, Chesterfield must be "insolvent" or "fail to pay its debts and liabilities from its assets as the same shall become due" in order to trigger personal liability. The court concluded that Chesterfield became "insolvent" when the lender exercised its option to accelerate the loan, the lender notified Chesterfield that the loan must be repaid in full and Chesterfield failed to pay the accelerated loan balance. The court relied on evidence that the amount due on the loan outweighed Chesterfield's assets, including the shopping center. Furthermore, the court found that Chesterfield's obligation under the promissory note to pay $103,483.14 on the first day of each month was a "debt" or "liability" that Chesterfield failed to pay "from its assets" or otherwise as of Dec. 1, 2009.

Chesterfield and Damico proffered several arguments, one of which was that the lender's interpretation of the "fail to pay" prong of Section 4.2(j) of the mortgage was overly broad, and caused the exception contained within Article 11(c)(ii) to swallow the rule of Article 11(a) of the promissory note. Chesterfield argued that if full recourse liability was triggered because Chesterfield failed to make a loan payment under Article 11(c)(ii), then Article 11(c)(i), which provides that a springing recourse event occurs when "the first full monthly payment of principal and interest under this Note is not paid when due" would not be necessary. If that were the case, Chesterfield and Damico argued, they would not be able to benefit from the nonrecourse protection granted to them under Article 11(a). The court rejected many of the defendants' arguments, including this one.

Many, if not most, of us would agree that this decision is not good law. Until this case is either overturned or discredited, the impact of this decision is that it should cause borrowers to look much more closely at the language in the carve-out guaranties being signed today before assuming the guaranty is strictly for bad-boy acts. A motion for reconsideration in the case has been filed. It remains to be seen what the final outcome of this case will be.

Today's carve-out guaranty is certainly not the same as the carve-out guaranty of the past. More than ever, borrowers, guarantors and their counsel must be careful in negotiating language contained in the loan agreement, mortgage and guaranty. This decision by the Michigan court demonstrates that lenders have been successful in expanding the scope of the carve-out guaranties to the point that these guaranties are merely disguised full-recourse guaranties. It is therefore essential for the borrower's and/or guarantor's counsel to make sure that the loan documents executed at closing provide guarantors with the requisite controls over acts that might potentially trigger personal recourse. ■