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Case Study: Wells Fargo V. Cherryland Mall

Law360, New York (January 27, 2012, 3:19 PM ET) -- The Michigan Court of Appeals recently held that a borrower's violation of a nonrecourse liability carve-out provision, which prohibited the borrower from becoming insolvent, resulted in the loan becoming fully recourse against the borrower. In Wells Fargo Bank NA v. Cherryland Mall Limited Partnership, et al., (Mich. App. Dec. 27, 2011), the court affirmed a lower court's imposition of liability upon both the guarantor and the borrower for more than $2 million of deficiency liability after foreclosure by the lender.

Background

Defendant Cherryland Mall Limited Partnership, the borrower, obtained a commercial mortgage-backed securities loan for which another defendant was the guarantor. The loan was then transferred to Wells Fargo Bank NA and made part of a real estate mortgage investment conduit trust. When Cherryland failed to make mortgage payments, the plaintiff foreclosed. After the sheriff's sale, the plaintiff was left with a deficiency of $2.1 million.

The plaintiff sued both the borrower and guarantor to enforce the loan documents and to obtain the deficiency, arguing, in part, that it was entitled to recover damages in the amount of the loan deficiency from Cherryland and the guarantor because Cherryland's insolvency constituted a failure to maintain its single purpose entity (SPE) status.

Eventually, the plaintiff filed several motions for summary disposition, seeking, among other things, a judgment for the deficiency. The trial court found for the plaintiff and granted all but one of the plaintiff's motions. The defendants appealed, objecting to the trial court's finding that the guarantor was liable for the entire deficiency because the borrower violated the SPE covenants when it became insolvent.

Michigan Court of Appeals Case Disposition

The court began the opinion with an examination of the typical structure of CMBS loans and noted that such loans often feature an agreement by the lender not to pursue recourse liability against the borrower, in exchange for the borrower agreeing to asset isolation which consists of "(i) separateness covenants and (ii) narrow limitations on the lender's general agreement not to pursue recourse liability ..."

This asset isolation, as stated above, often includes a series of "separateness covenants," pursuant to which the borrower agrees to "ring-fence" the financed asset from "all other endeavors, creditors and liens." These separateness covenants may include an agreement by the borrower to remain solvent. Limited recourse provisions are the other key element of asset isolation and are often triggered by certain "bad acts" on the part of the borrower which would allow the lender to pursue recourse as part of its remedies. Often, a breach of separateness covenants will constitute a triggering event, thus allowing the lender to seek recourse liability against the borrower and/or a guarantor.

Mortgage Was Not Extinguished Upon Foreclosure

On appeal, the defendants first argued that the mortgage was extinguished upon foreclosure, thus barring the plaintiff's lawsuit because it was initiated after the foreclosure sale, at which time the terms and conditions of the mortgage no longer existed. The court observed that the basis of an action at law for the deficiency on the statutory foreclosure of a mortgage is not the mortgage but the note itself.

The court looked to the language of the note which provided, in relevant part: "[n]otwithstanding anything to the contrary in this Note or any of the Loan Documents ... the Debt shall be fully recourse to Borrower in the event that ... Borrower fails to maintain its status as a single purpose entity as required by, and in accordance with the terms and provisions of the Mortgage ..." Based on this plain language, the court concluded that the terms of the note entitled the plaintiff to maintain a suit for deficiency.

Interpretation of the Contract Indicates That Loan is Full Recourse

The defendants also advanced several arguments based on their interpretation of the contract, arguing that they were not liable based on a violation of the SPE requirements. Specifically, the defendants argued that the terms of the mortgage were unambiguously nonrecourse and that the failure to remain solvent did not constitute a violation of SPE status. In support of these arguments, the defendants pointed out that the term "SPE" was never defined in the mortgage.

The court scrutinized the terms of the mortgage and the other loan documents. It noted that the requirement that the borrower remain solvent was included in the mortgage under the heading "Single-Purpose Entity/Separateness" and that all the covenants under such heading had to be met for the borrower to maintain its SPE status.

Said differently, the court concluded that the "natural and logical" conclusion was that solvency is a condition necessary to maintain SPE status. And because the loan documents stated in numerous places that the failure to maintain SPE status would result in the loan becoming fully recourse, the court found that the defendants' interpretation was unreasonable.

Conclusion

The court held that "[h]aving admittedly become insolvent, Cherryland violated the SPE requirements, resulting in the loan becoming fully recourse." As noted above, the court looked at the loan documents executed by the defendants and imposed full recourse liability on the borrower for the SPE covenant violations, which, in turn, triggered full recourse liability to the guarantor for the amount of the deficiency.

In so holding, the court acknowledged that its interpretation of the contract "seems incongruent with the perceived nature of a non-recourse debt." Nevertheless, the court maintained that it was neither its job to "save litigants from their bad bargains," nor to address matters of public policy. The judgments of the trial court were, therefore, affirmed.

Applicability of Holding

In sum, pursuant to this case, when negotiating carve-out provisions in loan documents, be aware that SPE covenants requiring solvency and adequacy of capital may in themselves trigger full recourse liability, without any accompanying outright “bad boy” acts.

To avoid such liability, the “solvency” and “failure to maintain adequate capital” provisions should be expressly excluded as full recourse triggers. Moreover, all SPE terms and conditions should be scrutinized carefully to avoid an unintentional result such as that reflected in Cherryland Mall, where a nonrecourse obligation is unintentionally converted into a full recourse obligation upon adverse market conditions.

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