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New Michigan Nonrecourse Mortgage Act Seeks to Restore Protections for Borrowers

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In a much-followed action, Michigan Gov. Rick Snyder recently signed into law the *Nonrecourse Mortgage Loan Act*, MCL Sec. 445.1591, et seq., which seeks to overturn two Michigan court decisions that interpreted and applied certain special purpose entity (SPE) and nonrecourse "carve-out" loan provisions in a manner that appeared to favor lenders and was outside of the expectations of commercial borrowers.

The Act states, in pertinent part, that:

> (1) A post closing solvency covenant shall not be used, directly or indirectly, as a non-recourse carve-out or as the basis for any claim or action against a borrower or any guarantor or other surety on a non-recourse loan, and
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> (2) A provision in the documents for a non-recourse loan that does not comply with subsection (1) is invalid and unenforceable.

MCL Sec. 445.1593. The Act became effective March 29, 2012.

The reason for the Act was to overturn two Michigan court decisions (colloquially known as the *Cherryland/Chesterfield* cases) that were a point of consternation for all sides of the real estate industry since they were decided last December. The result of those cases was to convert what most lenders and borrowers understood as a "bad-boy" carveout guaranty into a full recourse guaranty any time that an SPE became insolvent – despite the fact that the borrowers/guarantors did not engage in any malfeasance, or take any act to cause the insolvency, seek bankruptcy protection, or otherwise hinder or delay the lender's remedies against the property (i.e., no "bad acts" occurred). The borrower's cash flow troubles and underwater property were simply the result of the troubled real estate market and steeply declining values.

These case rulings hinged on the language in two key loan provisions: (i) the non-recourse carve-out section, which created a recourse event if the borrower failed to comply with the SPE provisions of the mortgage; and (ii) the SPE section itself, which had as one of its compliance obligations that the borrower "shall not become insolvent or fail to pay its debts and liabilities from its assets as the same shall become due." Based on the "unambiguous" language of the mortgage, the courts determined that when the borrower became insolvent (i.e., when the mortgage debt exceeded the value of borrower's assets and/or when the borrower failed to pay its debt when due by defaulting on the mortgage loan), the recourse provisions were triggered because of the breach of the SPE covenant. Thus, the borrower and, most importantly, the guarantor, were liable for the full mortgage debt.

The court rulings appeared to be a stroke of good fortune for lenders and dreadful news for borrowers and guarantors of mortgage loans in the CMBS market – while the Act appears to be the opposite, by restoring the generally understood parameters of nonrecourse carveouts to a standard familiar to borrowers and guarantors.

Despite the passage of the Act, the rulings in the *Cherryland/Chesterfield* cases may well continue to have impact, and it remains to be seen which side of the lender-borrower equation will truly benefit over the long run. As noted by a variety of sources, the effects felt from the *Cherryland/Chesterfield* decisions may include:

- Encouraging bankruptcy filings by borrowers and guarantors and contested foreclosures because some guarantors (almost invariably the principals or parent company of the borrower) will have nothing to lose if they are already full recourse obligors.
- Intertwining the borrower with its guarantor to such an extent that the argument for substantive consolidation of the borrower with a guarantor is more likely, thus defeating the purpose of having an SPE borrower in the first place.
- Calling into question the value and accuracy of tightly reasoned non-consolidation opinions given over the years.
- Raising the specter of lenders reopening old foreclosed transactions against guarantors previously considered "safe," which in turn has implications for lenders of subsequent loans that were counting on such guarantors' net worth and liquidity.

- Raising accounting concerns and a possible rethinking of reporting requirements on guarantors' balance sheets and financial statements as probable liabilities.

Stay tuned, as this story is not likely to be over. The possibility of a successful court challenge to the Act on constitutional grounds still exists (because of its retroactive effect and its interference with contract). And there is some political spice in the mix here as well, as the brother of the Michigan GOP chairman was a *Cherryland* guarantor who was the first beneficiary of the Act.