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ALERT

BANKRUPTCY REMOTE FINANCINGS IN JEOPARDY AFTER MICHIGAN APPELLATE COURT DECISION

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The proliferation of limited recourse financings popularized in the commercial mortgage backed securities (CMBS) loan market through the financial innovation of loan securitization may be in jeopardy following the decision of the Michigan Court of Appeals in *Wells Fargo, N.A. vs. Cherryland Mall Limited Partnership*.[1] If the Michigan decision is widely followed, an array of unanticipated consequences may arise that could have profound effects on the debt capital markets generally and on single purpose entity (SPE) borrowers in particular.

Structure of CMBS Limited Recourse Financings

A fundamental tenet of limited recourse financing in the CMBS market is asset isolation and borrower separateness. The basic bargain between lender and borrower includes limitations on the lender's ability to pursue recourse against the borrower or a loan guarantor in exchange for the borrower's compliance with covenants that prohibit it from commingling assets or cash flows and from combining operations with any other entity with whom it is under common control. This form of financing is prevalent in the real estate development industry and in other sectors where project-specific financing is necessary.

In the classic limited recourse financing structure, a corporate parent, holding company or affiliate forms a new legal entity as the borrower for the financing. The organizational documents of the newly formed entity (and the loan documents) will contain very extensive separateness and SPE covenants designed to achieve the requisite levels of isolation of the loan collateral and separate independent legal integrity of the borrower. A limited recourse guaranty typically is given by the borrower's parent or a corporate affiliate that is in a position of legal control over the borrower and that owns, directly or through its ownership of affiliated entities, net assets separate from and in addition to the borrower's assets.

As a financing mechanism, limited recourse CMBS loans are relied upon by commercial enterprises to insulate the enterprise from the risk inherent in any single project. Unlike traditional bank loans, with an important exception that will be discussed in this Alert, limited recourse loans generally do not contain extensive cross-default or cross-collateral provisions. In this sense, the impact of project failure is contained within the project itself.

In exchange for strict adherence to the separateness and SPE covenants by the borrower, the guarantor and their affiliates, the lender agrees to look solely to the assets financed for its source of repayment. The lender's ability to pursue recourse against the guarantor is intended to be limited to a narrow set of occurrences.

These so called “bad boy” acts fall into two separate categories. In the first category, acts such as fraud, intentional misrepresentation, misappropriation, waste or arson trigger recourse against the guarantor to the extent of the loss suffered by the lender. In the second category, any voluntary or collusive bankruptcy or insolvency filing by or on behalf of the borrower, a material breach of the separateness covenants or any breach of the covenants against asset transfers and encumbrances will trigger recourse against the guarantor for the total amount of the debt.

The Cherryland Case

In October 2002, Cherryland Mall Limited Partnership (Cherryland) obtained a mortgage loan guaranteed by one of Cherryland’s principals, David Schostak. The loan documents provided, among other things, that the borrower’s failure to maintain its status as an SPE in accordance with the terms of the mortgage would trigger the loan becoming full recourse to the borrower and the guarantor. The loan was subsequently transferred to Wells Fargo Bank, NA (Wells) and made part of a pool of CMBS loans in a real estate mortgage investment conduit trust.

An event of default occurred under the loan when Cherryland failed to make its August 1, 2009 mortgage payment. Wells foreclosed on the mortgaged property and was left with a deficiency of approximately $2.1 million on the loan following a foreclosure sale. In an effort to recover the deficiency, Wells sued both the borrower and the guarantor, arguing that Cherryland’s failure to make its mortgage payment constituted a breach of the SPE covenant that Cherryland remain solvent and pay its debts and liabilities as they become due and the loan had thus become full recourse to the borrower and the guarantor.

The plaintiff filed multiple motions for summary disposition, including a motion seeking a judgment against the guarantor for the entire loan deficiency. After the trial court granted this motion, the defendants appealed, objecting to the trial court’s finding that the guarantor was liable for the entire loan deficiency on the basis that Cherryland’s insolvency constituted a failure to maintain its SPE status.

The parties did not dispute that the loan documents provided for full recourse liability if Cherryland did not maintain its single purpose entity status. Rather, the dispute focused on what was required to maintain such status. The defendants argued that the loan documents, including the note, guaranty and mortgage, all failed to clearly define the term “single purpose entity” and that the provisions of the mortgage under the Section 9 heading titled “Single Purpose Entity/Separateness” were not clearly defined as SPE covenants. Additionally, amicus briefs submitted on behalf of the defendants by the Commercial Mortgage Securities Association and the Mortgage Bankers Association described these covenants only as “separateness covenants,” bolstering the argument that the mortgage did not contain any SPE covenants. However, the Court of Appeals rejected the defendants’ interpretation of the loan documents, finding that it was more logical to conclude that single purpose entity status and separateness are distinct concepts but are also intertwined, “such that maintaining SPE status requires abiding by the separateness covenants.”[2] Furthermore, the Court of Appeals found that although the loan documents did not explicitly define “single purpose entity,” the covenants listed in Section 9 of the mortgage were commonly considered SPE covenants based on a review of cases analyzing and interpreting loan documents with similar or identical section headings and covenants. Thus, the court held that compliance with all of the covenants listed in Section 9 of the Cherryland mortgage was necessary to maintain SPE status.

The defendants also argued that, even if the solvency requirement was an SPE covenant, it was not breached because the parties did not intend to make the loan full recourse to the guarantor unless the borrower became insolvent as a result of its intentional or willful bad acts. Thus, the defendants did not dispute that Cherryland was insolvent. They argued instead that Cherryland’s insolvency was not based on its own action but rather poor market conditions. The Court of Appeals rejected this argument as well, finding that the loan documents did not specify the manner in which the insolvency must occur in order to be a violation of the SPE covenant and, therefore, “any failure to remain solvent, no matter what the cause, is a violation.”[3]

Finally, the defendants also argued that a holding that interpreted the carve-out language to allow for the loan to become full recourse to the guarantor upon

Cherryland's insolvency for any reason was against public policy. The Court of Appeals recognized that its interpretation of the loan documents "seems incongruent with the perceived nature of a nonrecourse debt" and acknowledged that its interpretation could lead to "economic disaster for the business community."[4] Nevertheless, the court was unwilling to rescue the parties from their own bad bargain, stating that it was up to the legislature to address matters of public policy.

The *Cherryland* court specifically, and predictably, bounded its analysis in contract interpretation. Limited by precedent to this analytical framework, it concluded that strict, literal compliance with every covenant relating to separateness was essential to the borrower maintaining its SPE status. Although the covenant at issue had to do with the solvency of the borrower, the broader implications of the case are inescapable.

The court's conflation of the principles of separateness and single purpose-"ness" leads directly to a consideration of whether a failure to comply with *any* covenant should have the same consequence as failing to comply with *all* covenants. If so, the Cherryland holding implies that the more limited set of "bad boy act" recourse triggers are superfluous. This would appear to contradict (and undermine) the intentions of participants in the CMBS loan market – including borrowers, lenders, originators and servicers – a market in which hundreds of billions of dollars in loans have been issued, in part on the premise that some affirmative and conscious conduct by a loan party is required to trigger recourse.

It seems unlikely to have been the intent of these market actors that immaterial violations of minor separateness covenants were meant to have the same implications on lender recourse as more flagrant violations. Insofar as *Cherryland* makes no distinction among the possible causes of insolvency (volitional vs. involuntary) and leaves no room for the possibility that different degrees of covenant violations merit different implications on a lender's recourse remedies in an SPE financing, the case is not in keeping with the customs and practices of CMBS market participants.

Impact of the Cherryland Case

In response to the growth of the CMBS market and the pervasiveness of limited recourse financing, commercial enterprises have developed complex capital and organizational structures. One commonly used structure involves a parent company (which may in turn be a subsidiary of an ultimate holding company) that serves as a limited recourse guarantor on behalf of numerous SPE subsidiaries. In the context of a single parent guarantor and multiple SPE subsidiary borrowers, SPE loan provisions often include cross-defaults between and among these entities. With this familiar structure in view, the potential unintended consequences of the *Cherryland* case become evident.

Recourse against the parent guarantor triggered by a default of a single immaterial covenant of a single SPE subsidiary could result in a cascading series of related entity defaults across the entire corporate enterprise. If such a scenario were to occur, it would come as a surprise to nobody if a wave of bankruptcies engulfed the industry as real estate developers and other debt issuers that have relied heavily on SPE financing sought the protection of the courts.

The resulting restructuring transactions (whether in bankruptcy or otherwise) are likely to have very significant federal income tax implications for SPE borrowers and their corporate affiliates. Among other tax issues, borrowers are apt to incur material amounts of cancellation of indebtedness income (CODI) on which tax is owed. To the extent that the loan covenants prohibit the SPE borrower's ability to upstream funds, the CODI problem will be compounded by a phantom income issue if the borrower is a disregarded entity for federal income tax purposes and the parent is the ultimate taxpayer. With particular regard to real estate related enterprises that have accumulated assets through a series of tax deferred exchanges (e.g., under Internal Revenue Code Section 1031), deferred gains may be accelerated and realized as loans are discharged and the underlying properties are conveyed or transferred in corporate restructuring or reorganization transactions.

Conclusion

The use of common organizational structures by borrowing enterprises in the SPE loan market combined with the virtually complete adoption of industry standard loan documentation have conspired to make resolution of *Cherryland* a critical issue for the industry. As persuasive precedent, the case would provide a clear roadmap for other courts that narrowly construe the dispute as one of mere contract interpretation. To our knowledge, none of the presently reported cases challenging lender recourse under a limited SPE guaranty have been successful.

The yawning interpretative divide between the narrow scope of the *Cherryland* court's holding and the magnitude of the problem in the SPE limited recourse financing market may well be beyond the ability of the judicial system to resolve. Regulatory or legislative intervention may be required.

In point of fact, legislation known as the Nonrecourse Mortgage Loan Act was passed by the Michigan legislature and, on March 29, 2012, was signed by the governor. The legislation, which took immediate effect as Public Act 67, invalidates the *Cherryland* decision by rendering unenforceable deficiency judgments obtained against a borrower or guarantor that are based on violations of a post-closing solvency covenant.

In the interim, while the market sorts out the impact of the *Cherryland* case and the Michigan legislative backlash, there are steps every issuer should take on a "clear day" before defaults occur. First, commence an internal review of your loan portfolio and all related transaction documents to identify areas of possible default risk. Second, be proactive in engaging your lenders to seek concessions where necessary. Finally, be sure to retain competent and experienced counsel to guide you through these complex issues.

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[1] *Wells Fargo Bank, NA v. Cherryland Mall Limited Partnership*, No. 304682 (Mich. Ct. App. Dec. 27, 2011).

[2] *Wells Fargo Bank, NA v. Cherryland Mall Limited Partnership*, No. 304682, slip op. at 11 (Mich. Ct. App. Dec. 27, 2011).

[3] *Id*. at 15.

[4] *Id*. At 16.

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