Owners of CMBS Mortgage Encumbered Commercial Properties; Beware of Lessons Learned

By Steven D. Sallen[i]

We learned a lot about CMBS[1] loans, and the servicing companies that held them, and the attorneys who represented them, when the Great Recession of 2009 – 2010 resulted in wide-spread commercial mortgage loan defaults. The limited personal recourse provisions of some of those loan documents were used by some mortgage holders to gain leverage in ways that even the attorneys who represented the loan originators at loan inception could never have anticipated. In fact, in response to two Michigan court cases that shocked CMBS borrowers across the country, *Wells Fargo Bank, N.A. vs. Cherryland Mall Limited Partnership*[2] and *51382 Gratiot Avenue Holdings, LLC vs. Chesterfield Development Company, LLC*[3], the Michigan legislature enacted the *Nonrecourse Mortgage Loan Act* in 2012[4] . That law prohibited the use of post-closing solvency loan covenants from being used as the basis for seeking personal liability against borrowers and guarantors of loans that were otherwise understood to be non-recourse when they were made. The state of Ohio enacted a similar law in 2013[5]. Lessons learned during that difficult period bear remembering, as the commercial real estate industry is, once again, under tremendous strain on account of the current COVID-19 pandemic.

As the economy slowly begins to reopen, battle lines are being drawn as commercial landlords and tenants seek the economic high-ground as losses begin working their way through the economy. Reduced business results in reduced revenue. For many “non-essential” businesses, revenues have ground to zero. Without income tenants are looking for financial relief from anywhere they can get it, including from their landlords. No doubt, many reasonable and amicable rental concessions, deferrals, and other strategies will be negotiated in order to keep tenants paying rent (even if adjusted) and keep landlords paying their mortgages. But for owners of commercial properties encumbered by CMBS loans, the calculus for giving tenants any sort of rent concession is fraught with peril.

CMBS loans are generally *non*-recourse to the borrower, except to the extent of certain exceptions to the general non-recourse nature of the loan documents;

those exceptions – or *carveouts* – are typically guaranteed by one or more principals of the borrower. The carveouts are often referred to as the “bad boy” provisions of the loan documents. Loan brokers and originators frequently downplayed the danger of these carveouts by rationalizing that, if the borrower (and guarantor) don’t do anything “bad” then they would have nothing to fear concerning execution of the limited recourse guaranty. The carveouts fall into two categories; (i) those for which liability is limited to the extent of any loss, damage or other obligation actually incurred by the lender (including attorneys’ fees and costs incurred) arising in connection with a breach, and (ii) *springing*-recourse liabilities, which cause the entire loan to become *fully recourse* to the borrower and any guarantors. In other words, the non-recourse loan is magically converted into a fully recourse loan.

Undoubtedly and as a result of the COVID-19 pandemic, a new wave of commercial mortgage loan defaults is surely on the horizon. For those commercial property owners whose properties are encumbered by CMBS-type mortgages, there are very real concerns that, once again, some CMBS mortgage holders will seek to exert pressure against borrowers and their carveout guarantors by invoking certain carveouts, and the point of maximum pressure is to invoke a full recourse carveout. While we cannot anticipate all of the ways in which this is likely to happen, there are some typical springing-recourse carveout clauses that are likely to cause borrowers and guarantors significant grief in the not too distant future. One typical springing-recourse carveout provides for full recourse liability in the event a borrower admits its insolvency or its inability to pay its debts as they become due. If a borrower reports to its lender that one or more tenants has delayed or otherwise defaulted in paying its rent resulting in the borrower’s inability to pay its mortgage loan payments (one of “its debts”), this mere statement of the obvious could give a CMBS mortgage holder the leverage to exert maximum pressure by claiming that the entire loan is now fully recourse to the borrower and its guarantors. The takeaway here is that a borrower should never admit in writing that it cannot pay its debts, or any debt, or its mortgage loan payment, on account of having insufficient funds.

Another typical springing recourse carveout is triggered if a borrower fails to obtain its lender’s consent to any other “Indebtedness”, which is typically very broadly defined. For example, if a borrower obtains a loan under the new Payroll Protection Program, even though such loans may be partially or even fully forgivable, such additional debt would run afoul of the carveout against other debt. Even a loan given to a borrower by its principals so as to shore up its cash

position could be a violation of the carveout, and subject a borrower and its guarantors to full recourse liability. Borrowers should keep in mind that in most cases, the only way to inject additional cash into a borrowing entity, is by the infusion of equity capital, and not a loan of any stripe.

An even more nefarious effort to impose full recourse liability could be framed around a landlord's desire to help a struggling tenant. Another typical springing recourse carveout prohibits any *transfer* of the mortgaged property without the lender's consent. Transfers are generally thought of as any sale of all or any portion of the mortgaged property or the granting of any other mortgage or lien against the property, or creating any easement or other permanent encumbrance against the mortgaged property. Often, a clarification is added to the loan documents that leases within certain pre-approved parameters regarding minimum and maximum terms, minimum rental amounts and the like, are permitted, and are not to be construed to be an impermissible transfer of the property. We have already seen many national retail tenants request and, in some cases, demand rental concessions on account of the current pandemic situation. Some tenants are even unilaterally withholding rental payments, while invoking supposed abatement rights under leases and various other legal theories to claim a right to suspend, abate, or otherwise not pay rent while they are prohibited from opening their businesses. It is entirely likely that some owners will amend one or more leases without first obtaining their CMBS lender's consent, either by intentionally or accidentally overlooking those provisions of the loan documents that may require a lender's consent. Acquiescence with a unilateral rental remedy imposed by a tenant, such as described above, could even create a *de facto* lease amendment. It is entirely conceivable that a CMBS lender will determine that such unapproved lease amendments are an impermissible *transfer*, thereby triggering full recourse liability under a CMBS loan.

Commercial property owners with CMBS loans must tread carefully, so as not to unwittingly trigger full recourse liability. A careful review of the loan documents is essential when evaluating the impact of the current pandemic situation, on a property owner's ability to timely make its mortgage payments, and address the demands of its tenants for rental concessions and other relief. Also, keep in mind that the CMBS loan holder's decision-making process can be cumbersome and time consuming, including engaging the "special servicer" to approve certain lender decisions.

If history teaches us anything, it is that the holders of CMBS loans will, upon the

occurrence of a default in payment, exert every leverage they can to achieve the outcome that is best for them. CMBS borrowers are advised to be cautious in their decision making, and to carefully review their loan documents and consult with their legal counsel before making any significant decisions, even where such decisions make obvious business sense.

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[1] Commercial Mortgage Backed Securities
[2] 812 N.W.2d 799 (Mich. Ct. App. 2011)
[3] 835 F. Supp. 2d 384 (E.D. Mich. 2011),
[4] Michigan Compiled Laws § 445.1591
[5] Ohio Revised Code § 1319.07.

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