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Stay on the Nonrecourse Course

Borrowers must avoid certain actions after a default to avoid recourse liability

MANY COMMERCIAL MORTGAGE BOR-rowers seeking a loan workout or restructuring feel like they are practically forced to engage in strategic default — i.e., to stop making their loan payments to get their lender's or special servicer's attention. But an unintended circumstance follows: After a lender-declared default, borrowers no longer operate the property solely for their benefit but also for the lender, which may foreclose if a workout fails.

Borrowers have an implied, if not explicit, duty to continue to own and operate the secured property the same as or better than they did before default. This concept gets its teeth from what are known as bad-boy carve-outs, which are loan-document provisions that provide exceptions to nonrecourse liability.

Commercial mortgage brokers assisting in loan workouts or refinancing defaulted loans must understand what borrowers can and can't do in the post-default period.

Nonrecourse loans typically include borrower actions that can trigger full-springing-recourse clauses where a lender can sue to the extent of its losses or the loan becomes full recourse without limitation.

These acts typically include fraud, the property going to waste, gross negligence or criminal acts, misappropriation of borrower rent after default, and any sale or transfer of interests in the borrower. Other acts include the borrower filing for bankruptcy and a breach of single-purpose-entity provisions.

A borrower can unwittingly trigger recourse liability via activities commonly thought to be ordinary business operations. These include:

- **Failure to apply insurance** or condemnation proceeds properly to restore or repair the property;
- **Diversion or misapplication of security deposits and rents**;
- **Failure of the borrower to perform obligations** as landlord as per leases;
- **Physical neglect of the property**;
- **Economic waste of the property**;
- **Failure to discharge monetary liens**;
- **Failure to insure the property**;
- **Failure to obey applicable laws**; and
- **Failure to maintain the property**.

Lenders may be concerned with borrowers' failure to perform their obligations as landlord under leases in effect. Landlords with distressed properties often face rent-relief and lease-restructuring requests from tenants who otherwise may default and vacate.

Giving such lease concessions could be construed as not performing their landlord obligations. To be safe, these borrowers should provide their lender or servicer with copies of all lease amendments to existing "minor leases." They also should send a written request for consent to all lease amendments to existing "major leases."

Investor distributions also may trigger recourse liability post-default. Borrowers should consider whether distributing excess cash flow following a loan default constitutes "misapplication or diversion of rental income." Remember, the loan's collateral is not only the real estate but also the cash in the borrowers' bank accounts. To be safe, borrowers should not make any distributions to investors post-default.

Several recent cases indicate a trend of courts enforcing strict compliance with loan covenants and full enforcement of recourse liability based on breach of nonrecourse carve-out and springing-recourse provisions. Accordingly, mortgage brokers should advise their borrowers to dust off their loan documents and read them carefully. It will be better to err on the side of overcaution. ●

Note: This article was written for educational and informational purposes only and should not be construed as legal advice. Advise your clients to consult an attorney to determine what is legal and appropriate for their specific situation.

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