Emerging Statutory Threats to Recourse Triggers

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A new type of threat is emerging that may thwart special servicer collections: retroactive state legislation. For most CMBS collection actions involving nonrecourse loans, the issue of springing recourse triggers (so-called “bad boy guaranties”) rarely comes into play, but merely remains as part of the background against which the parties negotiate and maneuver. In the past, when the issue did come to the forefront, the special servicer merely had to analyze the contract language to determine whether a recourse trigger applied under the terms of the agreement. Unfortunately, this is no longer true in every state. Rather, two states, Michigan and Ohio, have recently passed statutes purporting to limit the enforceability of certain recourse triggers.

These legislative changes began following two Michigan decisions: *Wells Fargo Bank, N.A. v. Cherryland Mall Limited Partnership,* 812 N.W.2d 799 (Mich. Ct. App. 2011) and 51382 *Gratiot Avenue Holdings, LLC v. Chesterfield Development Company, LLC*, 835 F. Supp. 2d 384 (E.D. Mich. 2011). The cases involved a creditor's attempt to impose recourse liability on a borrower and guarantor for a mortgage deficiency in an otherwise non-recourse loan. The basis for the assertion of recourse liability lay in the alleged violation of covenants requiring the borrower to remain solvent. In both cases, the covenants were enforced as written and recourse liability was imposed.

In response to these cases, Michigan passed the "Nonrecourse Mortgage Loan Act," MCL 445.1591 through 1595 and, shortly thereafter, Ohio followed suit with nearly identical provisions in the Legacy Trust Act, 1319.07 through 1319.09. Stated simply, these statutes invalidate and nullify any springing recourse triggers based on solvency criteria. For example, if a non-recourse loan provides for springing recourse obligations if the borrower becomes insolvent, the statute would apply and invalidate that recourse obligation. The short summary then, is that Michigan and Ohio courts will not enforce insolvency-based recourse triggers. For a more nuanced application of Michigan's statute, including the exceptions for bankruptcy and normal recourse loans, as well as timing limitations on the solvency conditions, see the flow chart below. Ohio's law applies in substantially the same manner.

Beyond non-enforcement of solvency triggers in these states, there are several other worries for special servicers. First, these statutes apply *retroactively*, thereby invalidating contracts that were in existence before the passage of the statute. While such retroactive application would appear to raise serious issues regarding the impairment of contracts, at least one court (the *Cherryland* appeals court, on remand from the Michigan Supreme Court) has upheld the rule. Wells Fargo Bank, N.A. v. Cherryland Mall Ltd. P'ship, No. 304682 (Mich. Ct. App. Apr. 9, 2013); c*f.* U.S. Const. § 10, cl. 1 ("No state shall . . . pass any . . . law impairing the obligations of contracts . . ."); Allied Structural Steel Co. v. Spannaus, 438 U.S. 234, 257 (Brennan, J., dissenting) (noting that historical evidence supports the view that “the sole evil at which the Contracts Clause was directed was the theretofore rampant state legislative interference with the ability of creditors to obtain the payment or security provided for by contract . . . . The Clause was thus intended by the Framers to be applicable only to laws which altered the obligations of contracts by effectively relieving one party of the obligation to perform a contract duty."). Second, the Michigan enacting provisions describe the use of a "post closing solvency covenant" (i.e., a recourse trigger based on insolvency) in non-recourse loans as "an unfair and deceptive business practice." This raises the specter of lender liability based solely on the attempt to seek the application of a remedy explicitly provided for in the contract itself. Third, there is an ever-present danger of such state

legislation expanding to other jurisdictions or, even worse, additional state attempts to retroactively strike down contract provisions that the legislature finds distasteful (or that politically influential borrowers wish to avoid).

Despite these worries, there are still several positives. First, these rules are still confined to a handful of states. Second, the rules are relatively narrow, applying only to a specific type of non-recourse trigger that is absent from many CMBS loan documents. Third, special servicers and lenders facing such legislative obstacles can still attempt to raise constitutional objections to the retroactive application of these laws, which arguments (against a state's authority to impair preexisting contracts) may have better traction in federal courts.