"Springing Guarantee" fully enforced in non-recourse mortgage loan: district court holds guarantors liable for full deficiency claim for borrower's loan breaches including the failure to comply with separateness covenants

by David R. Kuney[1]

A recent decision by the United States District Court for Massachusetts held that a commercial mortgage lender was entitled to enforce a "springing guaranty" against the borrower's principals who had executed a guaranty with the traditional "carve outs" for certain acts, and made other rulings favorable to commercial mortgage lenders concerning separateness covenants, the right to accelerate a mortgage loan without notice or an opportunity to cure, and the measure of damages for breach of a springing guarantee. Blue Hills Office Park LLC v J.P. Morgan Chase Bank, 477 F.Supp. 2d 366 (D. Mass. 2007).

Blue Hills is significant for at least three key reasons; one, it permitted strict enforcement of the typical separateness covenants contained in securitized commercial mortgages; two, the court did not accept the borrower's superficial compliance with the independent director requirement; and three, the court permitted the lenders to recover the "full amount" of the deficiency after a foreclosure, without regard to whether the covenant breach caused the full loss. The Blue Hills case is particularly important given the relative paucity of cases dealing with "carve outs" and "springing guarantees," and the continuing debate over their enforceability.[2] If applied wisely, it will be a valuable addition to a lender's enforcement arsenal and bankruptcy strategy.

The facts. Blue Hills Office Park LLC ("Blue Hills") entered into a non-recourse mortgage loan with Credit Suisse First Boston Mortgage Capital LLC ("Credit Suisse") for $33,149,000 in 1999. The loan was secured by a first trust on an office building located at 150 Royall Street. The loan was guaranteed by William Langelier and Gerald Fineberg. J.P. Morgan Chase Bank ("JP Morgan") was the trustee for investors in the securitization trust which held the mortgage. The mortgage contained the conventional "carve-outs" from the non-recourse provisions, such as fraud, waste and the like.[3]

Loan default. Blue Hill's troubles began in April 2003 when it reached a settlement with an adjoining property owner over a requested permit to construct a parking garage. The

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[2] See, e.g., Heller Fin., Inc. v. Lee, 2002 U.S. Dist. LEXIS 15183, *2-5, 11 (N.D. Ill. Aug. 12, 2002). Heller Fin., Inc. v. Whitemark at Fox Glen, Ltd., 2004 U.S. Dist. LEXIS 18974 *3-6, 11-15 (N.D. Ill. 2004); FDIC v. Prince George Corp., 58 F.3d 1041, 1046-47 (4th Cir. 1995); First Nationwide Bank v. Brookhaven Realty Associates, 637 N.Y.S. 2d 418, 223 A.2d 618 (N.Y. App. 1996)(holding that a springing guaranty was enforceable against the borrower's partners, and rejecting the argument that such a clause is inequitable or oppressive).

But see Alvin L. Arnold and Marshall Tracht, Construction and Development Financing, §6:72 (3d ed.), [Westlaw citation is CDF §6:72] stating that "The enforceability of these instruments [springing and exploding guaranties] is an open question, and one that we can expect will be hotly contested come the next recession."

[3] A nonrecourse loan is one where the borrower is not personally liable for the debt upon default, but rather, the creditor's recourse is to the property granted as security for the loan. See Heller Fin., Inc. v. Lee, 2002 U.S. Dist. LEXIS 15183, *2-5, 11 (N.D. Ill. Aug. 12, 2002).

settlement resulted in the payment of $2.0 million to Blue Hills. The settlement monies were wired to an account at the law firm of the guarantor's lawyers, where they were later used to prosecute a claim against the lender.[4] Blue Hills did not notify JP Morgan of its receipt of the settlement funds. The mortgage lender later claimed the proceeds were part of the "Mortgaged Property" and should have been deposited into the borrower's account, and accused Blue Hills of "hiding the money in an attorney client funds account."[5] Later, it called it a "theft" of money.[6]

In May 2003, Blue Hills' major tenant, which leased over 96% of the building, announced it was moving. Without this major tenant, Blue Hills claimed it did not have the funds necessary to pay the loan payment due in August 2004, nor the real estate taxes. JP Morgan would later argue that Blue Hills had ample funds but had improperly secreted the monies in a non-borrower account. Blue Hills' chief financial officer asked Wells Fargo Commercial Mortgage Servicing ("Wells Fargo") the loan servicer, to pay the principal, interest and real estate taxes from the mortgage reserve account.[7] Wells Fargo did not respond to the letter, but it did pay the real estate taxes, and did agree in a letter that it would meet and discuss the "status of the loan."

Wells Fargo never met with Blue Hills, despite saying it would. In September, Blue Hills again failed to make its principal and interest payment and requested that Wells Fargo make the payment from the mortgage reserve account. Wells Fargo did not do so, but instead wrote a letter to Blue Hills stating that the loan had been in default since August 2004 (although no notice of default had been sent at that time) and had been fully accelerated, and making demand for full payment of the entire loan balance. A letter was sent to the guarantors in November 2004 advising them of the lender's intention to foreclose. No prior default notice and no opportunity to cure had been given to either Blue Hills or the guarantors.

Credit Suisse, which had reacquired the loan, foreclosed on the office building on November 19, 2004. The property was sold for $23 million, leaving a deficiency claim of over $10 million. Blue Hills then sued Credit Suisse and JP Morgan (the "Lenders") alleging that the Lenders breached the loan contract by declaring a default, wrongfully foreclosed, breached the duty of good faith, and violated the Massachusetts Consumer Protection Act. The Lenders counterclaimed against Blue Hills and the guarantors. A nine day trial ensued. The court granted judgment on all counts in favor of the Lenders.

Enforcement of Special Purpose Entity covenants ("SPE"); the independent director. The court in Blue Hills found in favor of the mortgage lender, and made several rulings concerning a borrower's covenant to maintain its status as single purpose entity (known

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[4] The court appeared to go out of its way to be critical of the borrower's legal counsel.

[5] J.P. Morgan's Opposition of Plaintiffs-in-Counterclaim to Motion of Defendants–in-counterclaim for summary judgment, filed on May 31, 2006. 2006 WL 1726432.

[6] Id. at p.3.

[7] The Mortgage allowed up to $1.0 million of the Leasing Escrow Funds to be used "solely" for application toward principal and interest under certain conditions. A significant portion of the litigation focused on whether J.P. Morgan wrongfully refused to permit the borrower to draw against the reserve. See e.g., Memorandum in Support for Summary Judgment of Defendant and Plaintiff-in-Counterclaim J.P. Morgan Chase Bank, as Trustee for the Registered Holders of Credit Suisse First Boston Mortgage Securities Corp., Commercial Mortgage Pass-Through Certificates, Series 1999-C1, filed May 17, 2006.

as "separateness covenants")[8]. The covenants at issue in Blue Hills included the obligation to have an independent director and not to commingle funds of the borrower with another entity. The requirement to maintain an independent director is typically required in a securitized transaction and requires that the independent director approve any decision by the borrowing entity to file for bankruptcy. The independent director, being more "objective" may decline to approve a bankruptcy filing. It may be safe to assume that many borrowers do not strictly comply with this requirement, or do so with a director who bears only the title, but none of the true responsibility.

The court in Blue Hills found that both the borrower and the guarantor breached the duty to have an independent director at all times. Blue Hills did in fact have a person who had the title of "director." However, the court found that the director did not actually participate in the management of Blue Hills and had recently worked as a paralegal or secretary for one of the defense firms. The director's failure to participate in the business caused the court to find that there was, in essence, a failure to have someone who truly functioned as an independent director. The court essentially disregarded the existence of a corporate officer.

Blue Hills suggests that merely having an ostensible director, who does not function in that role, may be viewed as having no director. This ruling by the court may prove useful in the context of a mortgage lender seeking to dismiss a single asset bankruptcy case on the grounds of "bad faith" or failure to obtain proper corporate authority to file the case. A lender might be able to argue that a debtor was not eligible to file for Chapter 11 because it lacked the required corporate authority. Case law suggests that a debtor which files for bankruptcy without complying with the entity's organic documents, such as the operating agreement of a limited liability company, may face dismissal.[9] Because many developers have independent directors who are remote from the business operations, Blue Hills might provide a basis to seek dismissal of a bankruptcy filing.

A more basic lesson from the Blue Hills decision is that the guaranty agreement itself should expressly incorporate the various separateness covenants. Many troubled borrowers may have equally passive or inactive directors, and this case helps create another basis to establish recourse liability on a springing guaranty where the recourse is limited to specific acts of misconduct.

Breach of the duty not to commingle assets. In Blue Hills, the court found that the borrower and guarantors had breached the separateness covenant by commingling the settlement funds of $2.0 million from the zoning dispute by transferring them to an account held by the guarantor's lawyers.[10] An important part of the decision was the court's determination that the monies received from the settlement of the zoning dispute constituted part of the lender's collateral, and came within the definition of the "Mortgaged Property." The court was also

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[8] Blue Hills, 477 F.Supp. 2d at 382.

[9] See In re Orchard at Hansen Park, LLC, 347 B.R. 822 (Bankr. N.D. Tex. 2006) dismissing Chapter 11 bankruptcy case of limited liability company where only one member approved the filing contrary to provisions in operating agreement that required unanimous consent.

[10] Lender's Opposition to Summary Judgment, p.15.

willing to find that the Lenders could rely on this as a default even though it was unaware of the misapplication of the funds at the time it accelerated the loan.[11]

Blue Hills is important because these separateness covenants create a barrier, even if partial, to the substantive consolidation of a borrower and its affiliates in a bankruptcy proceeding. This is to avoid the risk that the assets of the borrower will be claimed by creditors of an affiliate. Although a recent decision from the Third Circuit seems to limit the availability of the doctrine of substantive consolidation, and stated that the remedy should be used only in "rare" cases and as a "last resort,"[12] a recent statistical analysis shows that substantive consolidation in major cases remains very prevalent, and even dominant.[13] Substantive consolidation, however, can occur in smaller business cases,[14] and is certainly a possibility in real estate development, where the principals may have an ownership interest in many affiliated entities.

Amount of damages. An important issue in Blue Hills was whether the breach of the covenants created liability for the "full amount" of the debt (or deficiency) or only for the loss actually "caused" by the specific breach. The guaranty agreement in Blue Hills provided that the "guarantor shall be liable for the full amount of the Debt" in the event that the borrower transferred or conveyed any of the mortgaged property. However, another section of the guaranty agreement provided that in the event of certain actions, such as fraud or physical waste then the guarantor would be liable for "any loss or damage. . . caused thereby."

The court in Blue Hills noted the distinction between a guaranty which requires the guarantor to pay for any "loss or damage" caused by a covenant breach and one which requires the guarantor to pay the "full amount of the Debt."[15] The court found that the guarantor was expressly liable for the "full amount of the debt" based on the nature of the default and the language of the guaranty agreement. The court did not reach the issue of how the more limited damage remedy might apply. The Lenders, however, expressly recognized that a "loss or damage" interpretation could have significantly lowered their claim.[16] Thus, Blue Hills is significant in that it permitted enforcement of a covenant in a guarantee that permits the "full debt" liability to spring or "explode" even where the amount of damage directly caused by the breach is less.

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[11] The Lenders specifically argued that a lender can rely on defaults not then known unless the borrower can establish detrimental reliance on the default notice specifying only certain defaults. JP Morgan's Memorandum in Support of Summary Judgment, p.3.

[12] In re Owens Corning, 419 F.3d 195, 211 (3rd Cir. 2005).

[13] William H. Widen, "The Reality of Substantive Consolidation," July/August ABI Journal, Vol. 26, No. 6, p.14 (2007).

[14] See, e.g., Wells Fargo v. Sommers (In re Amco Insurance), 444 F.3d 690 (5th Cir. 2006).

[15] Blue Hills, 477 F.Supp. 2d at 381.

[16] The differences in the two theories was potentially significant in Blue Hills. For example, if the liability was only for loss or damaged "caused thereby" then the Lenders recognized that their claim might be only for the $2.0 million wrongfully placed into the principal's account. See JP Morgan's Opposition to Summary Judgment, p.15, n.9. However, if the covenant default triggered full recourse then the guarantors were liable for the full mortgage deficiency of over $10 million.

This ruling highlights an important issue that might arise where a lender seeks to enforce a springing guaranty based on the borrower's filing of a bankruptcy proceeding. The issue is the amount of recoverable damages where a guarantor is sued after a plan of reorganization has restructured a mortgage loan by reducing the principal amount of the loan, which is permitted under the "cram down" provisions found in 11 U.S.C. § 1129(b) of the Code. Could an argument be made that there was no "loss or damage" because the lender received the full amount to which it was entitled under federal bankruptcy law, and that "cram down" does not result in a "loss or damage?" Similar arguments have been made with success.[17] The decision in Blue Hills did not address this issue, but it does give voice to the distinction between a damages provision which permits recovery of a "loss" and one which makes the guarantor liable for the "full" debt. Lenders drafting guaranties should be careful to eliminate any ambiguity on what they intend.

Notice and cure issue. The Blue Hills case also made several key rulings concerning a lender's duty to provide notice and an opportunity to cure. The case is significant because it strictly construed the contract language in favor of the Lenders, and was not willing to import a "notice and cure" obligation from other parts of the mortgage instrument.

Blue Hills argued that the lender was in breach of contract for failing to provide the proper notice of default and an opportunity to cure. The mortgage stated that, "the Debt shall become immediately due and payable at the option of [Lender] upon the happening of any one" Event of Default.[18] The non-payment of real estate taxes was one of the twelve asserted defaults. However, another section of the mortgage provided that an Event of Default would occur if the Mortgagor "shall continue to be in default of any term, covenant or provision of the Note" beyond any applicable cure period, and if none, for thirty days after notice.

Blue Hills argued that the broader provision required notice and an opportunity to cure for "any" covenant. The argument was not frivolous. However, the court accepted the Lender's view that the broader provision was a "catch-all for other defaults that the Lender had not foreseen or specified in the mortgage agreement." Thus, it held that the failure to pay taxes amounted to an immediate default and did not require notice or an opportunity to cure.[19]

The Blue Hills decision is support for lenders seeking to enforce mortgage defaults and loan acceleration where the loan agreement does not expressly require notice or an opportunity to cure and by not importing onto some defaults the required notice and cure found in other sections of the loan agreement or mortgage.

A word of caution seems fair, however. Although the Lender prevailed, it might be better drafting to state precisely that certain defined acts give rise to an Event of Default, and that such

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[17] For a similar argument, see In re PPI Enterprises (U.S.) Inc., 324 F.3d 197 (3rd Cir. 2003), holding that a landlord was not "impaired" and hence could not vote on a plan where its claim was reduced by the statutory cap which is imposed on claims for unpaid future rent. The underlying logic of such a case is that the rights of a landlord are not altered or damaged by imposing the lawful cap on a claim.

[18] Mortgage, ¶23.

[19] The court did not address, and no one argued that the exercise of the "option" required some affirmative act, and that such act had to be manifested to the borrower. Other courts might have found that the "catch all" provision pertained to all events of default, or that the agreement was ambiguous, and would have permitted the parties to offer testimony on their intent.

events do not require notice or a cure. Further, relying on the lender's "option" to accelerate may invite an argument that the option had to be manifested in some way. A well defined body of case law holds that where a note provides for acceleration at the "option" of the holder "the note does not become due and payable by default alone," but rather requires an outward manifestation of such.[20]

Duty of good faith. Finally, Blue Hills addressed the covenant of good faith. A persistent defense by both borrowers and guarantors is the claim that the lender breached the implied duty of good faith and fair dealing. The implied duty of good faith is found in the Uniform Commercial Code and the common law of virtually every state would recognize the principle that, "[e]very contract implies good faith and fair dealing between the parties to it."[21] Broadly, this implied covenant of good faith provides that neither party may do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract.[22]

K.M.C. Co., Inc. v. Irving Trust, 757 F.2d 752 (6th Cir. 1985)("K.M.C."), gave the defense of breach of the duty of good faith high visibility, and since it was decided, many borrowers and guarantors have used an alleged breach of the implied duty of good faith and fair dealing as a defense to the enforcement of a loan or guaranty. K.M.C. involved allegations that a lender under a revolving line of credit, which had the right to stop making advances, breached the implied duty of good faith by refusing to make further advances (even though not required to do so) without first giving the borrower a reasonable opportunity to seek alternative financing. The Sixth Circuit held that this was a valid defense because the contract would be "illusory" if it placed one party wholly at the mercy of the other.

Blue Hills argued that K.M.C. should apply because the lender initially stated it would meet and discuss the status of the loan and then suddenly announced the loan had been accelerated without prior notice.[23] The court distinguished K.M.C. because that case involved a revolving line of credit, with a continuing duty to disburse, and not a mortgage loan which had been fully disbursed. Borrowers will argue that the "course of conduct" of the parties creates a waiver and that expressing a willingness to meet creates an obligation to do so. Blue Hills rejected such arguments. Nevertheless K.M.C. and the implied duty of good faith remain potent defenses for borrowers, and lenders are likely to see similar issues being asserted in enforcement actions.

Conclusion. The Blue Hills decision covered a broad array of borrower/guarantor defenses to loan and guaranty enforcement. Not only did the court reject many of them, but it showed a willingness to permit acceleration without notice, and to use violations of the

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[20] See e.g., 11 Am. Jur. 2d Bills and Notes § 196 (West 2007): "A note or other instrument providing for acceleration at the option of the holder does not become due and payable by a default alone; rather, some outward manifestation of the holder's intent to exercise that option is required. The creditor must perform some clear, unequivocal affirmative act evidencing an intention to take advantage of the acceleration provision, so as to leave no doubt as to the holder's intention and to apprise the maker effectively of the fact that the option has been exercised."

[21] See e.g., Anthony's Pier Four, Inc. v. HBC Associates, 411 Mass. 451, 583 N.E.2d 806 (Mass. 1991).

[22] See e.g., Druker v. Roland Wm. Jutras Assocs., 370 Mass. 383, 385, 348 N.E. 2d 763 (Mass. 1976).

[23] Blue Hills argued, among other things, that the Lender had sent a pre-negotiation letter also stating that it was authorized to "discuss and meet" and that it thereafter refused to meet. See J.P. Morgan Memorandum in Support of Summary Judgment, p.12.

separateness covenants as a basis to support the acceleration. Equally important, the court found the guarantors liable for the full amount of the loan, not just for damages "caused" by the breach of the covenant. Blue Hills may be the first in many cases in which borrowers seek to defeat loan covenants by arguing "bad faith" and defects in the notice and cure. Because Blue Hills requires a borrower to comply strictly with the terms of the mortgage, it represents an important case for the lending community.

As noted above, Arnold and Tracht, write that, "The enforceability of these instruments [springing and exploding guaranties] is an open question, and one that we can expect will be hotly contested come the next recession." Since the "next recession" may be closer than before, Blue Hills should be a significant precedent for mortgage lenders, as well as a guide for drafting techniques.