B

TexasBuilder

INSIDE TODAY'S New Building TECHNOLOGY

Official publication of the Texas Association of Builders

Route to: ❑ President ❑ Purchasing ❑ Sales/Mktg. ❑ Superintendent

PRSRT STD
U.S. Postage
PAID
Flint, MI
Permit No. 512

Inside:

Building Better Walls

Sign up for Sunbelt!

Builder Profile:
David Anderson Homes

by Brett L. Slobin

Legal Opinion

The Growing Contradiction Between Nonrecourse Loans and Personal Liability

A nonrecourse loan refers to a loan in which the borrower's liability is limited to the security for the loan. In other words, the lender is relying on the collateral, rather than the borrower's personal liability, to obtain repayment of the loan. In a typical real estate lending situation, the main collateral is the real estate that is the subject of the loan. Many developers of both commercial and residential real estate assume that they are obtaining nonrecourse loans from lenders because that is the type of liability they have requested from their lender.

However, this counselor's recent experience with lenders indicates that while lenders would like the borrower and guarantor of a loan to assume that they are securing a nonrecourse loan, the alleged nonrecourse lender's true intent has been to draft a nonrecourse loan that includes a list of "carveouts" that causes the loan to lose many of its nonrecourse characteristics.

Financial institutions began making nonrecourse loans in the late 1970s and early 1980s. After the collapse of the real estate market in the mid 1980s, many borrowers redirected loan proceeds and took other unscrupulous actions that exposed the true weakness that lenders had undertaken by making nonrecourse loans. As a result of these actions, lenders began adding carveout provisions in their loan documentation to hold the borrower and guarantor personally liable for taking dishonorable actions.

At first, the list of carveouts from the nonrecourse provisions of the loan documentation included actions that the borrower, guarantor and lender all uniformly agreed were dishonorable or "bad boy" activities, which result in personal liability for the borrower and the guarantor. Such carveouts included the following dishonorable or bad boy activities:

- Fraud, intentional misrepresentation or gross negligence
- Committing physical waste or damage on or to the property
- Misapplication of insurance or condemnation proceeds
- After an event of default, the failure to turn over the security deposits to the lender (applicable to an apartment project or other rental property)
- After an event of default, the failure to turn over to the lender the rental income from the property

> Many developers of both commercial and residential real estate assume that they are obtaining nonrecourse loans from lenders because that is the type of liability they have requested from their lender.

Unfortunately for borrowers and guarantors, as time has progressed, lenders have expanded the list of carveouts to include actions that most reasonably objective people would not perceive as dishonorable or bad boy activities. Because of this expansion, many borrowers have concluded that the concept of nonrecourse liability loans might have become extinct. The following list (while not exhaustive) sets forth a few examples of actions that lenders have attempted to add to the carveout list, even though such actions may have little to do with fraud, dishonorable acts or bad boy activities:

- The failure to pay the property taxes for the property
- After an event of default, any loss or damage arising from the failure to pay all debts and liabilities for labor, material and equipment or other charges incurred in the construction, maintenance, operation or development of the property
- After an event of default, any loss or damage resulting from the failure to manage, operate and maintain the property in a commercially reasonable manner for similar property types in the surrounding geographic area
- Transfer of title to the property without lender's consent
- Placing subordinate financing on the property without lender's consent
- Upon the foreclosure of the lien of the security instrument, damages resulting from the failure of borrower to deliver or surrender to the purchaser of the property, at or immediately following such foreclosure, any of the real and personal property covered by the security instrument or any other loan document

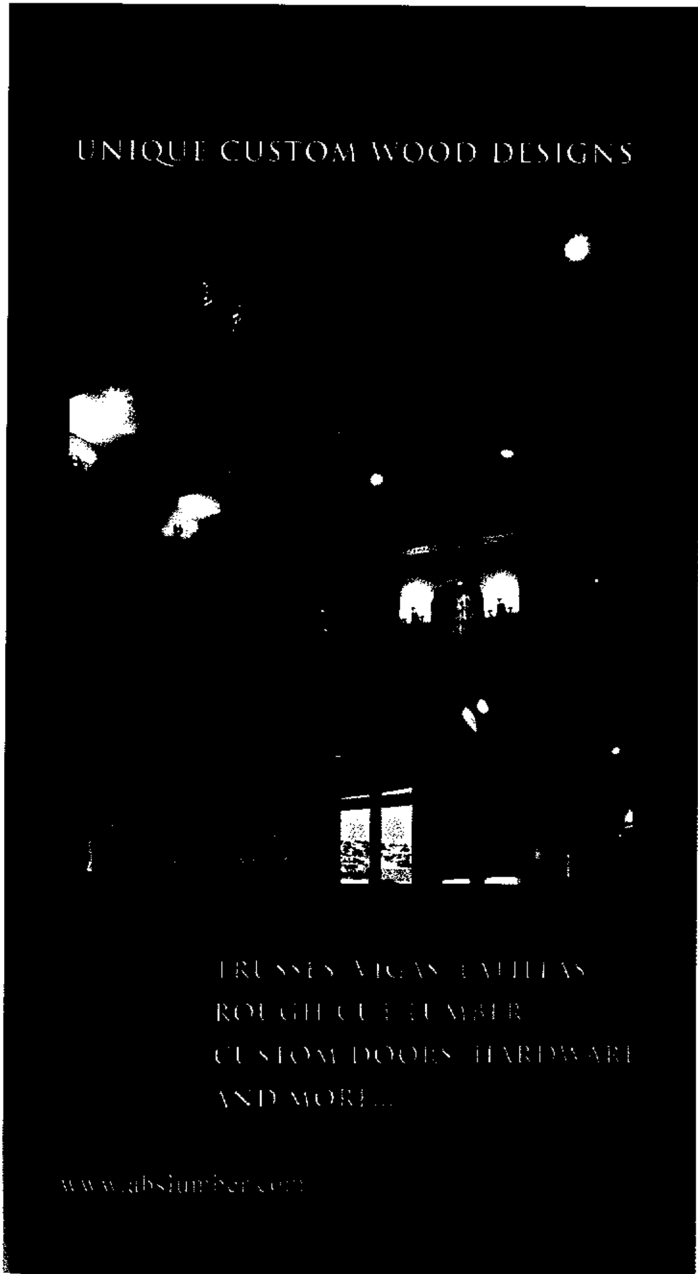
- Any actual loss resulting from the property, or any part thereof, becoming an asset in a voluntary bankruptcy or insolvency proceeding filed by a party other than borrower, guarantor, or any affiliate of borrower or guarantor, which is not dismissed within ninety (90) days of filing

The borrower's failure to pay any valid taxes for the property should not be a carveout if there is so little cash flow from the property that the borrower can't reasonably pay for taxes on the property. Rather, this provision should be modified to state that the borrower and guarantor will be personally liable for the loan if, even though there is sufficient cash flow to pay for any valid taxes, the borrower fails to apply such cash flow to payment of any valid taxes. Similarly, the borrower should not be liable, after an event of default, for failure to manage the property in a commercially reasonable manner or for the failure to pay all of the debts and liabilities of the property if there is insufficient cash flow.

Additionally, the borrower and guarantor should not be held personally liable for either the transfer of title to the property without the lender's consent or for the placement of secondary financing of the property. While the lender will maintain that it must assure itself that the property is operated and managed by a competent owner, the borrower should respond that the lender can always exercise the "due on sale" provision or the prohibition against secondary financing in the loan documentation. With regard to the balance of the above-mentioned carveouts, the key is that the borrower or guarantor should not incur personal liability merely because the borrower or the property becomes uneconomical and can not pay its debts as they become due.

Borrowers must pay close attention to each document enclosed within their loan documentation. This should require rigorous examination of each loan document by a competent and qualified attorney. If the borrower does not take these necessary steps to protect itself, then the borrower and guarantor may risk the loss of their personal assets after the default of what they genuinely, but mistakenly, thought was a nonrecourse loan.

Brett L. Slobin is an attorney in the Houston law firm of Slobin & Slobin P.C., and he can be reached at bslobin@slobinlaw.com. His practice focuses on commercial and residential real estate.



Home Builders Insurance Services
888-287-7414

- Builders Risk • Auto
- Workers Compensation
- General Liability (includes Completed Operations)

Home Builders Insurance Services dedicated exclusively to Home Builders and Subcontractors.

Because your insurance needs are unique HBIS offers tailor made coverage for Home Builders.

Serving Texas with over 25 years experience and top rated carriers at two convenient locations.

HBIS

Or Visit us Online at
www.hbisonline.com

Dallas
Waxahachie