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# Wait . . . What Do I Owe You? Searching for the True Meaning of Non-Recourse Financing After *Cherryland v. Wells Fargo*

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Wait . . . What Do I Owe You?  
Searching for the True Meaning of Non-Recourse Financing After *Cherryland v. Wells Fargo*

**INTRODUCTION**

On December 27, 2011, the Michigan Court of Appeals sent real estate investors nationwide into a panic when it decided *Wells Fargo Bank, N.A. v. Cherryland Ltd. P'ship*.<sup>1</sup> The court's decision enforced a loan agreement despite several terms and conditions of the agreement being contrary to the accepted industry understanding.<sup>2</sup> According to various amici curiae participating in this case, wide-spread economic disaster would likely result if the loan agreement was held to be enforceable in its entirety.<sup>3</sup> In spite of these warnings, the Michigan Court of Appeals held that it was not their job to "save litigants from their bad bargains or their failure to read and understand the terms of the . . . [loan agreement]."<sup>4</sup>

As a result of the Michigan Court of Appeals decision, both defendants, Cherryland Limited Partnership (the "borrower" or "Cherryland") and the loan's guarantor David Schostak ("guarantor" or "Schostak"), were faced with a judgment of over \$2 million.<sup>5</sup> Defendants, seeking relief, requested leave to appeal the Court of Appeals' ruling to the Michigan Supreme Court.<sup>6</sup> In lieu of granting leave to appeal, the Michigan Supreme Court remanded the matter back to the Court of Appeals for reconsideration in light of the recently enacted Nonrecourse Mortgage Lending Act ("NMLA").<sup>7</sup> The NMLA retroactively prohibits certain loan provisions

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<sup>1</sup> *Wells Fargo Bank, N.A. v. Cherryland Mall Ltd. P'ship*, 295 Mich. App. 99, (Mich. Ct. App. 2011).

<sup>2</sup> *See id.* at 126.

<sup>3</sup> *Id.*

<sup>4</sup> *Id.*

<sup>5</sup> While many real estate investors choose to create a separate entity (Cherryland in the present case) to be the owner of their investment property, a lender may require the loan documents to be signed by an individual member (Schostak in the present case) member to guaranty the loan, as to provide the lender with a "warm body" to seek relief from in the event of a problem.

<sup>6</sup> *Wells Fargo Bank, N.A. v. Cherryland Ltd. P'ship*, 493 Mich. 859, 859 (Mich. 2012).

<sup>7</sup> *Id.*

from being used as a basis for a claim against a borrower, guarantor, or other surety involved in a non-recourse loan.<sup>8</sup> Despite Wells Fargo’s (“plaintiff”) arguments that the NMLA violated multiple constitutional provisions, the Michigan Court of Appeals upheld the NMLA as constitutional on remand. As such, the loan provisions that were held enforceable by the Michigan Court of Appeals were per se invalid under the NMLA , and Wells Fargo \$2 million judgment against the defendants was unenforceable.<sup>9</sup>

This Note will argue that New Jersey should adopt legislation similar to that of Michigan’s Nonrecourse Mortgage Lending Act (“NMLA” or “the Act”) to prevent New Jersey’s courts from enforcing these types of counter-intuitive loan provisions, and to eliminate the requisite costs needed to litigate these disputes. Part I of this Note will describe some background knowledge on commercial mortgages that is necessary to understand and appreciate the issues presented in the *Cherryland* case. This background will include brief explanations of commercial loans, the Commercial Mortgage Backed Securities (“CMBS”) market and asset isolation, as it relates to non-recourse financing. Part II of this Note will summarize the *Cherryland* decision and emphasize the court’s application of contract interpretation principles. Additionally, this Note will discuss the Michigan Legislature’s enacting of the NMLA, and the court’s interpretation of constitutional principles to uphold the act. Part III of this Note will compare and contrast the holding in *Cherryland* to similar cases involving the strict enforcement of loan agreements, and discuss the considerable amount of outstanding loan agreements that could be affected by terms similar to those in *Cherryland*. Part IV of this Note will conclude with a summary of the tension between strict contract interpretation and public policy presented in

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<sup>8</sup> *See id.*

<sup>9</sup> *Wells Fargo Bank, N.A. v. Cherryland Ltd. P’ship*, 300 Mich. App. 361, 370, 385 (Mich. Ct. App. 2013); *Cherryland*, 295 Mich. App. 99, at 106-07.

*Cherryland*, and will recommend that New Jersey enact legislation similar to NMLA to avoid the turmoil that would result from the enforcement of a *Cherryland*-like provision without legislative relief.

## **I. BACKGROUND**

The *Cherryland* court presents forthright principles of contract interpretation. However, their inclusion in the context of a complex commercial real estate mortgage transaction requires a familiarity with commercial real estate financing and the CMBS market.

### **A. Understanding the CMBS Market**

Prior to the CMBS market, commercial banks, savings and loan institutions, and other lenders often financed commercial real estate.<sup>10</sup> For these types of mortgages, each lender holds the loan, or a portion of the loan on its own balance sheet. Some choose to sell pieces of the loan through participation agreements with other lenders.<sup>11</sup> Often, smaller banks use loan use these agreements to share in the ownership of a loan to provide a better lending product to borrowers and increase each lender's respective income from the loan.<sup>12</sup>

In contrast, A CMBS loan involves a lender making “mortgage loans to unrelated entities, then deposit[ing] each of the loans into a trust that would issue securities in the public or private markets backed by the cash flow and collateral from the pool or mortgage loans.”<sup>13</sup>

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<sup>10</sup> Amended Brief of Amici Curiae With Respect To The Filing of Voluntary Petitions In Bankruptcy By The Individual Property Owner Subsidiaries In The General Growth Properties, Inc. Bankruptcy, In re Gen. Growth Props., 409 B.R. 43, (Bankr. S.D.N.Y. 2009) (No. 09-11977) (submitted on behalf of the Commercial Mortgage Securities Association and Mortgage Bankers Association).

<sup>11</sup> *Id.*

<sup>12</sup> See Lone Participation Note, INVESTOPEDIA, <http://www.investopedia.com/terms/l/loanparticipationnote.asp>.

<sup>13</sup> *Id.*

Although CMBS loans are notoriously more complex than their traditional balance sheet counterparts, the overwhelming majority of all commercial loan agreements today include a first mortgage on the real property, and a promissory note or guaranty allowing the lender to collect payment from the borrowing entity and/or the guarantor himself or herself.<sup>14</sup> In the context of most commercial mortgages, the guarantor is typically a human being, an individual capable of acting as a co-signor to the borrowing entity in the event the borrowing entity cannot fulfill its obligation to lender.<sup>15</sup>

### **B. Non-Recourse Financing & Asset Isolation**

A fundamental element of CMBS financing is the isolation of the asset being financed from all of the other assets the borrower owns. The general bargain between lender and borrower is that the lender agrees not to pursue liability directly or indirectly against the borrower or guarantor himself or herself (thereby making the loan non-recourse), so long as the borrower promises to isolate the asset being financed from “all other endeavors, creditors and liens related to the parents of the property owner or affiliates, and from the performance of any assets owned by such parent entity or affiliates.”<sup>16</sup>

In addition to the isolation of the asset itself, there must be an isolation of the cash flows originating from the operation of the asset.<sup>17</sup> It is out of this cash flow that the borrower makes mortgage payments.<sup>18</sup> These payments later get distributed “to the holders of the securities issued backed by such mortgages.”<sup>19</sup> Protection of an uninterrupted cash flow from securitized assets is

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<sup>14</sup> *Id.*

<sup>15</sup> *See generally* Guarantor, INVESTOPEDIA, <http://www.investopedia.com/terms/g/guarantor.asp>

<sup>16</sup> *Id.*

<sup>17</sup> *Id.*

<sup>18</sup> *Id.*

<sup>19</sup> Amended Brief of Amici Curiae With Respect To The Filing of Voluntary Petitions In Bankruptcy By The Individual Property Owner Subsidiaries In The General Growth Properties, Inc. Bankruptcy, In re Gen. Growth Props., 409 B.R. 43, (Bankr. S.D.N.Y. 2009) (No. 09-11977) (submitted on behalf of the Commercial Mortgage Securities Association and Mortgage Bankers Association).

the “sine qua non” of CMBS financing.<sup>20</sup> There are two components to asset isolation, the separateness covenants (“Separateness Covenants”) and a narrow list of exceptions to the lender’s promise not to pursue the borrower or guarantor personally for any liability (“Limited Recourse Provisions”).<sup>21</sup>

### **1. Separateness Covenants**

Separateness covenants are crucial to CMBS financing as they prevent the owner of an asset from partaking in activities that may jeopardize the lender’s claim against that specific asset.<sup>22</sup> For example, an owner cannot place additional debt or liabilities on the asset, or take any action that could possibly result in a claim against the asset being financed.<sup>23</sup> Although often thought of as a unitary concept, separateness covenants are a collection of individual and independent promises made by a borrower to their CMBS lender.<sup>24</sup> A borrower that maintains all of the separateness covenants is sometimes referred to as a single purpose entity (“SPE”).<sup>25</sup>

### **2. Limited Recourse Provisions**

Despite the lender agreeing to an otherwise non-recourse CMBS loan, certain bad acts (“recourse triggers”) on the part of the borrower will trigger the enforcement of dormant recourse language within the loan agreement against the borrower and guarantor.<sup>26</sup> Examples of common recourse triggers include: (a) fraud or intentional misrepresentation by the borrower or guarantor;

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<sup>20</sup> *Id.* (as CMBS loans are packaged and sold as described above, the more reliable a property’s cash flow is, the lower the risk of default, the more valuable the loan).

<sup>21</sup> *Id.*

<sup>22</sup> *Id.*

<sup>23</sup> *Id.*

<sup>24</sup> *Id.*

<sup>25</sup> Compare *supra* text accompanying notes 20-23 (explaining separateness covenants as preventing the owner of an asset from being involved in activities inconsistent with ownership of that specific asset, with *Cherryland*, 295 Mich. App. at 117 (citing *U.S. CMBS Legal and Structured Finance Criteria*, Standard and Poors, May 1, 2003, at 89) (defining a single purpose entity as “an entity, formed concurrently with or immediately prior to the subject transaction, that is unlikely to become insolvent as a result of its own activities and that is adequately insulated from the consequences of any related party’s insolvency.”).

<sup>26</sup> *Id.*

(b) misappropriation or misapplication of rents or tenant security deposits; (c) breach of the separateness covenants; or (d) voluntary bankruptcy filings, or involuntary bankruptcy filings if collusive.<sup>27</sup> The specific loan agreement will dictate whether the recourse language will create liability that is limited to the lender's losses stemming from the triggering activity, or liability for the entire loan balance due, regardless of the amount of actual lender losses.<sup>28</sup>

## **II. WELLS FARGO, N.A. V. CHERRYLAND LIMITED PARTNERSHIP**

### **A. The Facts**

In 2002, Cherryland obtained an \$8.7 million CMBS loan from Archon Financial, LP, ("Archon") offering as collateral a shopping mall in Garfield Township, Michigan.<sup>29</sup> At the closing, Cherryland executed the promissory note, the mortgage, assignments, and other documents.<sup>30</sup> Schostak signed the guaranty.<sup>31</sup> (Collectively these documents will be referred to as the "loan documents.")<sup>32</sup> As is common in CMBS loans, the Cherryland loan was packaged and sold into a trust comprised of other CMBS loans.<sup>33</sup> The plaintiff Wells Fargo Bank, N.A. was the trustee of the group of mortgages that included the Cherryland loan.<sup>34</sup>

In 2009, Cherryland become insolvent, and was unable to make the mortgage payment due on August 1<sup>st</sup> of that year.<sup>35</sup> Wells Fargo began the foreclosure process, and the sheriff's sale was held on August 18, 2010.<sup>36</sup> In many sheriff's sales, property is purchased by the foreclosing

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<sup>27</sup> *Id.*

<sup>28</sup> *Id.*

<sup>29</sup> *Wells Fargo Bank, N.A. v. Cherryland Mall Ltd. P'ship*, 295 Mich. App. 99, 105 (Mich. Ct. App. 2011).

<sup>30</sup> *Id.*

<sup>31</sup> *Id.*

<sup>32</sup> *Id.* (

<sup>33</sup> *Id.*

<sup>34</sup> *Id.*

<sup>35</sup> *Cherryland*, 295 Mich. App. at 105.

<sup>36</sup> *Id.*

party, usually the lender.<sup>37</sup> The foreclosing party is allowed to bid up to the balance owed on the loan without having to bring any additional capital to pay for the transaction.<sup>38</sup> This type of bidding places interested third parties at a disadvantage needing to come up with cash.<sup>39</sup> In *Cherryland*, Wells Fargo, the party looking to foreclosure here, ultimately won the sheriff's sale by bidding \$6 million, leaving them with a deficiency on the balance owed of approximately \$2.1 million.<sup>40</sup> On the day after the foreclosure sale, Wells Fargo filed a lawsuit in the Grand Traverse Circuit Court ("the lower court") against both Cherryland Limited Partnership (the borrowing entity), and Schostak, (the guarantor on the loan), personally to enforce the loan documents.<sup>41</sup> Wells Fargo contended that they had the right to recover the \$2.1 million deficiency from both Cherryland and Schostak, because Cherryland's insolvency and subsequent foreclosure constituted a failure by the borrower to maintain its status as a single purpose entity ("SPE"). A failure to maintain SPE status is a breach of a separateness covenant, which, pursuant to Paragraph 13 of Cherryland's promissory note, activates one of the Cherryland's loan recourse triggers.<sup>42</sup> After hearing all arguments, the lower court entered final judgment on behalf of the Wells Fargo, ruling that both defendants, Cherryland Limited Partnership and David Schostak were liable for the \$2.1 million deficiency.<sup>43</sup> On March 28, 2001, the defendants moved for reconsideration in which the lower court denied.<sup>44</sup>

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<sup>37</sup> FED. HOUS. FIN. AGENCY, OFFICE OF INSPECTOR GEN., AN OVERVIEW OF THE HOME FORECLOSURE PROCESS ([http://fhfa.ig.gov/Content/Files/SAR%20Home%20Foreclosure%20Process\\_0.pdf](http://fhfa.ig.gov/Content/Files/SAR%20Home%20Foreclosure%20Process_0.pdf))

<sup>38</sup> *Id.*

<sup>39</sup> *Id.*

<sup>40</sup> *Cherryland*, 295 Mich. App. at 105.

<sup>41</sup> *Id.* at 106.

<sup>42</sup> *Cherryland*, 300 Mich. App. at 367 (Paragraph 13 of the promissory note provides "[T]he debt shall be full recourse to [b]orrower in the event that . . . [b]orrower fails to maintain its status as single purpose entity as required by . . . the terms and provisions of the [m]ortgage.").

<sup>43</sup> *Cherryland*, 295 Mich. App. at 107, 114.

<sup>44</sup> *Id.*

Defendants appeal the lower court’s decision, and assert that the court erred in finding that insolvency of Cherryland as the borrowing entity was a breach of its SPE status.<sup>45</sup> The appellate court took notice of specific language in the loan documents stating, “the note, mortgage, and guaranty all provide, in nearly identical language, that the loan debt becomes fully recourse with respect to the borrower . . . or the guarantor . . . in the event that Cherryland fails to maintain its status as a single purpose entity as required by, and in accordance with the terms and provisions of this Mortgage.”<sup>46</sup>

The court found that no dispute existed between the parties that the loan documents provided a recourse trigger if Cherryland failed to maintain its status as an SPE.<sup>47</sup> Instead, the appellate court disputed the meaning and interpretation of the phrase, “as required by, and in accordance with the terms of provisions of the Mortgage,” that was contained in the Cherryland loan documents.<sup>48</sup> In other words, there was a disagreement about what Cherryland needed to do to maintain its SPE status.<sup>49</sup> Cherryland and Schostak contend that either “the mortgage was unambiguously nonrecourse and insolvency was not a violation of Cherryland’s SPE status or [in the alternative] that the mortgage was ambiguous and the extrinsic evidence presented showed that solvency [of the borrower] was not required to maintain SPE status.”<sup>50</sup>

### **B. Contract Interpretation**

The obligation of the court in interpreting a contract is to determine the intent of the contracting parties.<sup>51</sup> As a matter of law, unambiguous contractual provisions are reflective of

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<sup>45</sup> *Id.* (

<sup>46</sup> *Id.* at 111.

<sup>47</sup> *Id.*

<sup>48</sup> *Id.*

<sup>49</sup> *Cherryland*, 295 Mich. App. at 111.

<sup>50</sup> *Id.*

<sup>51</sup> *Quality Prods. & Concepts Co. v. Nagel Precision, Inc.*, 495 Mich. 362, 375 (Mich. 2003).

the parties' intent.<sup>52</sup> An ambiguous contract presents a question of fact that needs to be decided by a trier of fact.<sup>53</sup> A contract is ambiguous when it presents language capable of conflicting interpretations.<sup>54</sup>

In Cherryland's loan documents, the disputed language is located in portions of both the mortgage agreement and guaranty agreement.<sup>55</sup> The heart of Cherryland and Schostak's argument is that Paragraph 9 of the mortgage agreement conflicts with both the integration clause of the guaranty agreement, and Paragraph 43 of the mortgage agreement.<sup>56</sup> Paragraph 9, subsection (f) of the mortgage agreement is entitled "Single Purpose Entity / Separateness," which reads: "Mortgagor is and will remain solvent and [m]ortgagor will pay its debts and liabilities (including, as applicable, shared personnel and overhead expenses) from its assets as the same shall become due."<sup>57</sup>

Cherryland and Schostak first asserted that Paragraph 9 of the mortgage agreement was flawed, and couldn't have been a recourse trigger, because it did not define single purpose entity.<sup>58</sup> Normally, when terms are not defined in a contract, the court will interpret that term in conformity with its most commonly used meaning in that particular trade.<sup>59</sup> However, Cherryland and Schostak argued that the integration clause of the guaranty agreement excluded all extrinsic evidence.<sup>60</sup> Following this logic, they claimed that any attempt to define "single purpose entity" with extrinsic evidence be barred. The appellate court responded stating that an

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<sup>52</sup> *Id.*

<sup>53</sup> Klapp v. United Ins. Grp. Agency, 468 Mich. 459, 468 (Mich. 2003).

<sup>54</sup> *Id.* at 467.

<sup>55</sup> *Cherryland*, 295 Mich. App. at 111, 116.

<sup>56</sup> *Id.* at 115-16, 118-19.

<sup>57</sup> *Id.* at 113-14.

<sup>58</sup> *Id.* at 155.

<sup>59</sup> Terrien v. Zwit, 467 Mich. 56, 76-77 (Mich. 2002) (quoting Henderson v. State Farm Fire & Cas. Co., 460 Mich. 348, 354 (Mich. 1999)), Ososki v. St Paul Surplus Lines, 156 F. Supp. 2d 669, 675 (E.D. Mich. 2001).

<sup>60</sup> *Cherryland*, 295 Mich. App. at 116.

integration clause did not prevent extrinsic evidence from defining an otherwise undefined term.<sup>61</sup> The appellate court ultimately concluded that although the mortgage did not specifically define a single purpose entity, the concept of a single purpose entity was intertwined with, and required abiding by the concept of separateness covenants thereby making the term single purpose entity logical and unambiguous.<sup>62</sup>

Second, Cherryland and Schostak asserted that Paragraph 9 of the mortgage agreement conflicted with Paragraph 43.<sup>63</sup> Paragraph 43 of the mortgage agreement provided that headings and captions “are for convenience of reference only and are not to be construed as defining or limiting in anyway . . .”<sup>64</sup> Despite Cherryland and Schostak’s efforts to persuade the court that Paragraph 9 should be viewed solely as a heading, as a reference point in the document, the appellate court noted that doing so would violate an established rule of contract interpretation by rendering multiple portions of the loan documents referencing the term single purpose entity meaningless.<sup>65</sup>

While recognizing that no cases have directly held that an insolvency clause violates a borrower’s SPE status, the appellate court cited supporting case law from other jurisdictions, that have interpreted the breach of other covenants under a similar heading of “Single Purpose Entity/Separateness” as triggering full recourse liability.<sup>66</sup>

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<sup>61</sup> *Cherryland*, 295 Mich. App. At 116; see 5 ARTHUR LINTON CORBIN ET AL., CORBIN ON CONTRACTS §24.12 (1998) (stating when “the court seeks merely to interpret a contract term, which is to discern the meaning of a term already contained in the contract, the question of whether the parties intended their agreement to be integrated is not relevant.”).

<sup>62</sup> *See supra* note 24.

<sup>63</sup> *Cherryland*, 295 Mich. App. at 118-19.

<sup>64</sup> *Id.* at 119.

<sup>65</sup> *Id.* at 118-19 (citing *Laurel Woods Apartments v. Roumayah*, 274 Mich. App. 631, 638 (Mich. App. Ct. 2007) (quoting *Klapp v. United Ins. Grp. Agency*, 468 Mich. 459, 468 (Mich. 2003) (“A court must ‘give effect to every word, phrase, and clause in a contract and avoid an interpretation that would render part of the contract surplus or nugatory.”))).

<sup>66</sup> *Cherryland*, 295 Mich. App. 99 at 120-125.

In *LaSalle Bank N.A. v. Mobile Hotel Props., LLC*<sup>67</sup>, the Eastern District Court of Louisiana held that the borrower's amendment of its articles of organization and acquiring of new debt without the lender's consent breached covenants in the "Single Purpose Entity/Separateness" section of the mortgage thereby triggering the full recourse provisions of the loan.<sup>68</sup>

Similarly, in *Blue Hills Office Park, LLC v J.P. Morgan Chase Bank*<sup>69</sup>, the District Court of Massachusetts found that the borrower failed to maintain its status as an SPE, and ultimately faced full recourse liability, because it transferred portions of the mortgaged property without the lender's consent.<sup>70</sup>

Cherryland and Schostak, in their final argument, alternatively argued that Paragraph 9 was unambiguous but had not been breached as the borrower did not reach insolvency due to intentional actions, but rather from the declining conditions in the commercial real estate market.<sup>71</sup> The court rejected this argument recognizing that Paragraph 9 of the mortgage did not require a scienter element to be enforceable.<sup>72</sup>

### **C. Public Policy Analysis**

In delivering its decision, the appellate court recognized that its interpretation of the loan documents, specifically provision 9(f) of the mortgage agreement, was incongruent with the

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<sup>67</sup> *LaSalle Bank N.A. v. Mobile Hotel Props., LLC*, 367 F. Supp. 2d. 1022, 1029. (E.D. La. 2004).

<sup>68</sup> *Id.* (noting that included in the Single Purpose Entity/Separateness Provision were fourteen covenants (including a solvency clause) and that violation of any of these fourteen would result in a breach, and the triggering of full recourse liability.).

<sup>69</sup> *Blue Hills Office Park, LLC v. J.P. Morgan Chase Bank*, 477 F. Supp. 2d 366, 382-83 (D. Mass. 2007).

<sup>70</sup> *Id.* at 382 (stating that in addition to the covenant not to transfer parts of the mortgaged property without lender's consent, there were many other covenants listed under the "Single Purpose Entity/Separateness" section of the mortgage including one that required that the borrower remain solvent).

<sup>71</sup> *Cherryland*, 295 Mich. App. 99 at 125.

<sup>72</sup> *Id.* at 125-26 (referencing *LaSalle Bank N.A. v. Mobile Hotel Props., LLC*, 367 F. Supp. 2d. at 1030) ("It is irrelevant that [the borrower] did not ever engage in, any activity other than the operation of the hotel property. Its motive for amending its Articles of Organization is also irrelevant. . . .").

well-understood practice of non-recourse financing.<sup>73</sup> The court was aware that if the predictions of the amici curiae are correct, the business community in Michigan will suffer economically if the lower court's interpretation of mortgage provision 9(f) was upheld.<sup>74</sup> However the appellate court recognized that these documents were clearly written, and fairly standardized in the industry, and stated "it is not the job of this Court to save litigants from their bad bargains or their failure to read and understand the terms of a contract."<sup>75</sup>

Cherryland and Schostak's pleaded to avoid enforcement of the challenged loan provision and the \$2 million judgment against them.<sup>76</sup> They argued that enforcing such a counter-intuitive provision would be a violation of public policy. The appellate court denied Cherryland and Schostak relief, and stated that the Michigan Supreme Court has regularly held that it is the role of the Michigan Legislature's to address matters of public policy, not the judiciary.<sup>77</sup>

#### **D. The Holding & Subsequent Appeal**

Relying on the rules of contract interpretation coupled with the persuasive authority of other courts decisions on the interpretation of similar loan documents to those in the present case, the Michigan Court of Appeals affirmed the decision of the lower court, and enforced mortgage provision 9(f).<sup>78</sup> Cherryland admittedly became insolvent, thereby triggering the full recourse

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<sup>73</sup>*Cherryland*, 295 Mich. App. 99 at 126. (Traditionally, so long as a borrower did not purposefully breach the agreed upon provisions in the loan documents, the loan would remain non-recourse. Insolvency stemming from a recession and subsequent decline in property values is not typically thought of as a purposeful act in violation of the loan documents, and therefore wouldn't normally be thought to trigger any recourse provisions.).

<sup>74</sup> *Id.*

<sup>75</sup> *Id.* See also *Farm Bureau Ins. Co. v. Nikkel*, 460 Mich. 558, 567 (Mich. 1999) (stating that "This court has . . . held that one who signs a contract will not be heard to say, when enforcement is sought, that he did not read it, or that he supposed it was different in its terms.") (internal citation omitted); *Allied Supermarkets Inc. v. Grocers Dairy Co.*, 391 Mich. 729, 737 (Mich. 1974) (stating that "A court of equity may not be used either as a lever to raise a better offer of redemption or as the means of avoiding the consequences of a legal contract now regarded as a bad bargain.").

<sup>76</sup> *Cherryland*, 295 Mich. App. 99 at 126. See *In re Kurzyniec Estate*, 404 Mich. 524, 542 (Mich. 1979)

<sup>77</sup> *Id.* (holding "[a]s a general rule, making social policy is a job for the Legislature, not the courts").

<sup>78</sup> *Cherryland*, 295 Mich. App. At 128.

provisions of the loan documents. Defendants dissatisfied with the outcome, and fearful of the repercussions of this decision, appealed to the Michigan Supreme Court on December 27, 2011.<sup>79</sup> On September 26, 2012, in lieu of granting leave for appeal, the Michigan Supreme remanded this case back to the Michigan Court of Appeals in light of the Legislature’s recent passing of the Nonrecourse Mortgage Loan Act (“NMLA”).<sup>80</sup>

## **E. The Nonrecourse Mortgage Lending Act**

### **1. Legislative Intent and Operative Language**

The Michigan legislature recognized that inherent in non-recourse financing is the premise that “the lender assumes the risk of a borrower's insolvency, inability to pay, or lack of adequate capital after the loan is made and that the parties do not intend that the borrower . . . [be] personally liable for payment of a nonrecourse loan if the borrower is insolvent.”<sup>81</sup>

Provision 9(f) of the mortgage agreement in *Cherryland* was a post-closing solvency requirement, the enforcement of which created personal liability for the defendants.<sup>82</sup> The NMLA defines a post closing solvency covenant as “any provision of the loan documents for a nonrecourse loan, whether expressed as a covenant, representation, warranty, or default, that relates solely to the solvency of the borrower, including . . . a provision requiring that the borrower maintain adequate capital or have the ability to pay its debts, with respect to any period of time after the date the loan is initially funded.”<sup>83</sup>

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<sup>79</sup> See *Wells Fargo Bank, N.A. v. Cherryland Mall Ltd. P’ship*, 493 Mich. 859, 859 (Mich. 2012).

<sup>80</sup> *Id.*

<sup>81</sup> MICH. PUB. ACTS NO. 67 (2012).

<sup>82</sup> See MICH. COMP. LAWS SERV. §445.1592.

<sup>83</sup> MICH. COMP. LAWS SERV. §445.1592.

“[T]he use of a post closing solvency covenant as a nonrecourse carveout, or an interpretation of any provision in a loan document that results in a . . . post closing solvency covenant . . . [being used as a] nonrecourse carveout, is inconsistent with this act and the nature of a nonrecourse loan; is an unfair and deceptive business practice and against public policy; and should not be enforced.”<sup>84</sup>

The Legislature, appreciating the severity of the matter on hand promulgated that the NMLA apply to “the enforcement and interpretation of all nonrecourse loan documents in existence on, or entered into on or after the effective date of this act.”<sup>85</sup>

## **2. The Plaintiff’s Challenges to the NMLA**

### **a. The Guaranty Agreement**

The plaintiff references §1.1 and §1.3 of the guaranty agreement that defendant Schostak executed, arguing that Schostak’s obligations and liabilities were “unconditional, irrevocable, and absolute.”<sup>86</sup> Further, in §2.4 of the guaranty agreement, Schostak expressly waived “any statutory rights regarding the ‘invalidity, illegality, or unenforceability of . . . any document or agreement executed in connection with the Guaranteed Obligations’ agreeing that his obligations . . . would not be ‘released, diminished, impaired, reduced, or adversely affected.’”<sup>87</sup>

Despite plaintiff’s arguments, the court found that the NMLA, in provisions §445.1593(1) and (2) clearly provide that a “post closing solvency claim covenant shall not be used directly or indirectly, as a nonrecourse carveout or as the basis of any claim or action against . . . any guarantor.”<sup>88</sup> As such, the court finds that any provision in the mortgage or

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<sup>84</sup> MICH. PUB. ACTS NO. 67 (2012). *See also* MICH. COMP. LAWS SERV. §445.1593 (containing the operative provision of the NMLA).

<sup>85</sup> MICH. COMP. LAWS SERV. §445.1595.

<sup>86</sup> *Cherryland*, 300 Mich. App. 361, 370.

<sup>87</sup> *Id.* (citation omitted).

<sup>88</sup> *Cherryland*, 300 Mich. App. 361 at 370.

guaranty agreement that attempts to link the personal liability of Schostak with a post closing solvency covenant be held invalid and unenforceable.<sup>89</sup>

## b. Constitutionality

The plaintiff challenges the constitutionality of the NMLA, arguing that the legislation violated the Contracts Clause, Substantive Due Process, and the Separation of Powers.<sup>90</sup>

### 1. Contracts Clause

“No State shall . . . pass any Bill of Attainder, ex post facto Law, or Law impairing the Obligation of Contracts”<sup>91</sup>

First, the plaintiff, in arguing that the NMLA is an unconstitutional impairment on an existing contract rely on *Sturges v. Crowninshield*<sup>92</sup> and *Walker v. Whitehead*,<sup>93</sup> both holding that “states could change a remedy if no substantial contract rights were impaired but *could not discharge the obligations of a debtor.*” (emphasis added).<sup>94</sup> However, the court recognizes that there has been movement away from the once bright-line rule of no relief for debtors / obligors.<sup>95</sup> Currently, whether or not a state violated the Contract Clause is a determination made after referencing a three-step test as put forward in *Energy Reserves Grp. v. Kansas. Power & Light Co.*<sup>96</sup>

The court must first determine whether the state legislation is operating as a substantial impairment on the contractual relationship.<sup>97</sup> If it is determined that a substantial impairment

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<sup>89</sup> *Id.* at 371.

<sup>90</sup> *Id.* at 371-72, 379-385.

<sup>91</sup> U.S. CONST. art. I, §10, cl 1.

<sup>92</sup> *Sturges v. Crowninshield*, 17 U.S. 122, 199-201 (4 Wheat 1819).

<sup>93</sup> *Walker v. Whitehead*, 83 U.S. 314, 318 (16 Wall 1873).

<sup>94</sup> See cases cited *supra* notes 88-89.

<sup>95</sup> See *Blue Cross & Blue Shield v. Milliken*, 422 Mich. 1, 20 (Mich. 1985)(referencing *Home Bldg. & Loan Assn. v. Blaisdell*, 290 U.S. 398 (1934)(construing the Contract Clause as containing an internal balancing test, weighing the degree of impairment to the parties against the justification of the use of the state’s police power)).

<sup>96</sup> *Energy Reserves Grp. v. Kan. Power & Light Co.*, 459 U.S. 400, 411-413 (1983).

<sup>97</sup> *Id.* at 411.

exists, the court must next examine whether the legislation is based on a legitimate public purpose.<sup>98</sup> Finally, if a legitimate public purpose can be identified, the court must look at whether the legislatures interference in the rights and responsibilities of the contracting parties is reasonable and appropriate to the public purpose purportedly being served.<sup>99</sup>

Addressing the three part *Energy Reserves* test, the court, despite not reaching a conclusion as to whether the NMLA created substantial impairment, was able to conclude that there was a legitimate public person behind the legislation, and that the remedy provided was reasonable and appropriate.<sup>100</sup>

In reaching its conclusion that a legitimate public purpose existed, the court looked to testimony given at the Senate Economic Development Hearing held prior to the passing of the NMLA which warned of irreparable harm to the investment environment in Michigan, a collapse of non-recourse lending, a decrease in tax revenues, and the heightened the risk of additional foreclosures.<sup>101</sup>

In determining the reasonableness and appropriateness of the legislature's enactment of the NMLA, the court, giving deference to the legislature's judgment, and without a proposed lesser measure capable of accomplishing the target objective, held that the NMLA does not violate the Contracts Clause.<sup>102</sup>

## 2. Substantive Due Process

“No State [shall] deprive any person of life, liberty, or property, without due process of law.”<sup>103</sup> The due process clause also contains a substantive component, which protects individual

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<sup>98</sup> *Id.* at 411-412.

<sup>99</sup> *Id.* at 412 (referencing *United States Trust Co of N.Y. v. New Jersey*, 431 U.S. 1, 22 (1977)).

<sup>100</sup> *Cherryland*, 300 Mich. App. at 374.

<sup>101</sup> *Id.* at 375-76 (referring to *Hearing on S.B. 922 Before the S. Econ. Dev. Comm.*, (Mich. 2012)).

<sup>102</sup> *Cherryland*, 300 Mich. App. at 379.

<sup>103</sup> U.S. CONST. amend. XIV, § 1.

liberties and property interests from the implementation of arbitrary government procedures.<sup>104</sup> When evaluating the NMLA, the court recognized that “[r]etroactive legislation presents problems of unfairness . . . more serious than . . . proposed legislation, because it can deprive citizens of legitimate expectations, and upset settled transactions.”<sup>105</sup> In order to find that the NMLA satisfied Michigan’s due process test of “whether the legislation bears a reasonable relation to a permissible legislative objective,” the court referenced the various negative economic ramifications discussed in the Senate Economic Development Committee, and held that the NMLA was a rational means of addressing the identified problem.<sup>106</sup> Therefore, the court did not find that the NMLA violated substantive due process.<sup>107</sup>

### 3. Separation of Powers

“The powers of government are divided into three branches . . . [n]o person exercising powers of one branch shall exercise powers of another branch except as expressly provided.”<sup>108</sup> Plaintiff argued that the Legislature’s passing of the NMLA deprived the Michigan Court of Appeals of its power to understand and enforce the mortgage agreement.<sup>109</sup> However, because the Michigan Court of Appeals order had an appeal pending, the NMLA did not disturb a final judgment.<sup>110</sup> Specifically in instances where retroactive legislation is passed, a court is required

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<sup>104</sup>*Cherryland*, 300 Mich. App. 361, 379-80 (referencing *Bonner v. City of Brighton*, 298 Mich. App. 693, 705-06 (Mich. App. Ct. 2012)).

<sup>105</sup> *Cherryland*, 300 Mich. App. at 380 (quoting *Gen. Motors Corp. v. Romein*, 503 U.S. 181, 191 (1992) (quoting *Pension Benefit Guar. Corp. v. R.A. Gray & Co.*, 467 U.S. 717, 730 (1984))).

<sup>106</sup> *Phillips v. Mirac, Inc.*, 470 Mich. 415, 436 (Mich. 2004) (quoting *Detriot v. Qualls*, 434 Mich. 340, 366 (Mich. 1990)). See *Cherryland*, 300 Mich. App. at 382.

<sup>107</sup> *Cherryland*, 300 Mich. App. at 382.

<sup>108</sup> MICH. CONST. art. III, §2.

<sup>109</sup> *Cherryland*, 300 Mich. App. at 382.

<sup>110</sup> See *Detroit v. Arms Tech., Inc.*, 258 Mich. App. 48, 65 (Mich. Ct. App. 2003) (holding that the enactment of firearm distribution legislation did not violate the separation of powers clause as an appeal of the trial court’s decision was pending).

to apply the new law to any pending cases so long as the appeal process is in process.<sup>111</sup> For these reasons, the court held that the NMLA does not violate the Separation of Powers clause.<sup>112</sup>

### **3. On Remand: The Holding**

On April 9, 2013, the Michigan Court of Appeals rejected the plaintiff's constitutional challenges to the NMLA, and held that the new legislation bars plaintiff's claims from moving forward.<sup>113</sup>

### **III. ANALYSIS**

The Michigan Court of Appeals' decision to enforce provision 9(f) of the mortgage agreement, albeit harsh, was correct. First, it is simply is not the job of the court to save a party from a bad bargain, nor to decide matters of social policy.<sup>114</sup> Despite the defendants and amici curiae alleging that provision 9(f) violates public policy, and therefore should not be enforced, policymaking is best left for the Legislation, not the judiciary.<sup>115</sup> Once the Legislature passed the NMLA, the new law was properly interpreted, and led to the correct result when reviewed on remand.

While the court properly administered straightforward principles of contract interpretation discussed herein, the court mistakenly analogized *Cherryland* to decisions in other jurisdictions upholding the enforcement of various *different* SPE covenants.<sup>116</sup> (emphasis added). In *Mobile Hotel Props.*, the defendant breached the covenants prohibiting the amending of its articles of organization, and by incurring additional debt.<sup>117</sup> In *Blue Hills Office Park*, the

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<sup>111</sup> *Cherryland*, 300 Mich. App. at 384.

<sup>112</sup> *Id.* at 385.

<sup>113</sup> *Id.* at 361, 361.

<sup>114</sup> *Cherryland*, 295 Mich. App. at 126-27.

<sup>115</sup> *See id.* at 127(finding that the Legislature has superior access to gather data, facts, opinions, and evaluate the will of the public); *In re Kurzyniec Estate*, 207 Mich. App. 531, 543 (Mich. Ct. App. 1994).

<sup>116</sup> *See supra* text accompanying notes 65-68.

<sup>117</sup> *Mobile Hotel Props.*, 367 F. Supp. 2d. at 1029.

defendant failed to maintain its status as an SPE because it transferred parts of the mortgaged property without lender's consent.<sup>118</sup> The decisions both *Mobile Hotel Props.* and *Blue Hills Office* illustrate clear principles of contract interpretation, and present straightforward breaches of unambiguous SPE covenants.<sup>119</sup> Holding parties responsible for their bargains is not inequitable, and severe repercussions for breaches of contract are not per se violations of public policy. However, two noteworthy distinctions can be made between *Cherryland* and *Mobile Hotel Props.* and *Blue Hills Office*. First, both *Mobile Hotel Props.* and *Blue Hills Office* were cases involving intentional and purposeful breaches of loan covenants.<sup>120</sup> Second, neither of the holdings *Mobile Hotel Props.* or *Blue Hills Office Park* holds the borrower responsible for breaching an SPE covenant that is counterintuitive to the basic principles of non-recourse debt as is the solvency covenant in provision 9(f) found in *Cherryland*.<sup>121</sup>

#### **A. Contract of Adhesion**

While not addressed in *Cherryland*, defendants may have been able to frame their general public policy argument against provision 9(f) more quantitatively as a contract of adhesion. Michigan determines whether a provision is an unenforceable contract of adhesion by applying a two-prong test of “procedural and substantive unconscionability: (1) What is the relative bargaining power of the parties, their relative economic strength, the alternative sources of supply, in sum what are their options?; (2) Is the challenged term substantively reasonable?”<sup>122</sup>

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<sup>118</sup> *Blue Hills Office Park*, 477 F. Supp. 2d at 382-83.

<sup>119</sup> See *Blue Hills Office Park*, 477 F. Supp. 2d at 382-83; *Mobile Hotel Props.*, 367 F. Supp. 2d. at 1029.

<sup>120</sup> See *Blue Hills Office Park*, 477 F. Supp. 2d at 382-83; *Mobile Hotel Props.*, 367 F. Supp. 2d. at 1029.

<sup>121</sup> See MICH. PUB. ACTS NO. 67 (2012) (stating that inherent in non-recourse financing is the premise that “the lender assumes the risk of a borrower's insolvency, inability to pay, or lack of adequate capital after the loan is made and that the parties do not intend that the borrower . . . [to be] personally liable for payment of a nonrecourse loan if the borrower is insolvent.”); *Blue Hills Office Park*, 477 F. Supp. 2d at 382-83; *Mobile Hotel Props.*, 367 F. Supp. 2d. at 1029

<sup>122</sup> *Koza v. Act, Inc.*, No. 206007, 1999 Mich. App. LEXIS 2170, at \*30 (Mich. Ct. App. Dec. 10, 1999).

Addressing the bargaining power of the parties at the time of the contract, prior to Wells Fargo, Archon Financial, L.P., the originator of the CMBS loan, was a fully owned subsidiary of Goldman Sachs.<sup>123</sup> With reported net income in 2012 of over \$7.47 billion, the bargaining power and economic strength of Goldman Sachs is evident.<sup>124</sup> Unlike the more traditional scenario finding a contract of adhesion, a mortgage agreement between a lay-borrower seeking a loan from a big bank on a single family home, the borrower here, more specifically, the guarantor, David Schostak, was an executive of Schostak Brothers & Company, a full service real estate development, management, leasing, and consulting company operating commercial properties on a national scale.<sup>125</sup> A reasonable inference can be drawn that David Schostak, as an executive of a national real estate company, had an attorney review the loan documents in dispute prior to executing them, and has been involved in commercial real estate financing transactions before. Defendants, here failed to argue with any specificity that there was an inequity in negotiating power in the original transaction that would compel a court to take action.<sup>126</sup>

### **B. Why Should We Care?**

*Cherryland* has not been the only example of recent litigation surrounding the enforcement of a post closing solvency covenant in loan documents in Michigan.<sup>127</sup> In *51382 Gratiot Ave. Holdings v. Chesterfield Dev. Co.*,<sup>128</sup> the defendants stopped making payments on a commercial mortgage and went into default.<sup>129</sup> The property was sold at a foreclosure auction to

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<sup>123</sup> ARCHON GROUP, <http://www.archon.com> (last visited Oct. 31, 2013).

<sup>124</sup> *GS Income Statement*, YAHOO! FINANCE, <http://finance.yahoo.com/q/is?s=GS&annual>.

<sup>125</sup> *About Us*, SCHOSTAK BROTHERS & COMPANY, <http://www.schostak.com/aboutus.htm> (last visited Oct. 31, 2013).

<sup>126</sup> See Amaris Elliot-Engel, *Superior Court Rules Contract-of-Adhesion Argument Waived*, The Legal Intelligencer (July 23, 2013), <http://www.law.com/jsp/pa/PubArticlePA.jsp?id=1202611619892&thepage=2> (discussing a Superior Court decision finding that the loan documents did not represent a contract of adhesion because the borrower was a major business enterprise “with the capacity to pledge hundreds of thousands of dollars,” and “there . . . [was] no indication that the deal was between a giant corporation and minor 'mom-and-pop' consumers.”)

<sup>127</sup> See *51382 Gratiot Ave. Holdings, LLC v. Chesterfield Dev. Co.*, 835 F. Supp. 2d 384 (E.D. Mich. 2011).

<sup>128</sup> *Id.*

<sup>129</sup> *Id.* at 388.

plaintiffs, and much like the facts in *Cherryland*, plaintiffs brought an action against the defendants to recover the deficiency on the balance owed to them.<sup>130</sup>

Understood by both parties to be a non-recourse loan, the dispute is over a provision in the mortgage agreement stating that the borrower shall not "become insolvent or fail to pay its debts and liabilities from its assets as the same shall become due."<sup>131</sup> Much like the argument that came later in *Cherryland*, defendants here argue that this provision "does violence to the very nature of commercial mortgage-backed security loans, . . . and the court's enforcement of those provisions as written will have disastrous consequences in the real estate market."<sup>132</sup>

The court ultimately decided in the favor of the plaintiffs, holding that it "does not sit to propagate or enforce best business practices; instead, . . . its duty to give effect to discrete agreements executed by individual parties."

## **1. The Scope of the Problem**

The Mortgage Bankers Association has recently reported that there is approximately \$2.45 trillion in outstanding commercial and multi-family mortgage debt, \$557 billion of which were CMBS originations.<sup>133</sup> While, there has not yet been a definitive answer as to the percentage of commercial mortgages include post closing solvency provisions in their loan documents, the Commercial Real Estate Finance Council ("CREFC") estimates this figure at around 10% of all outstanding commercial mortgages, not just CMBS loans.<sup>134</sup>

## **2. Affected Parties**

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<sup>130</sup> *Id.*

<sup>131</sup> *Id.* at 392.

<sup>132</sup> *Id.* at 401.

<sup>133</sup> *Mortgage Debt Outstanding, Q2 2013*, MBA COMMERCIAL REAL ESTATE / MULTIFAMILY FINANCE (September, 2013), <http://mba.org/files/Research/CommercialServicing/Q213CMFDebtOutstanding.pdf>.

<sup>134</sup> Brief of the CRE Finance Council as Amicus Curiae, at 126, *Wells Fargo, N.A. v. Cherryland Ltd. P'ship*, 295 Mich. App. 99 (Mich. Ct. App. 2011) (No. 304682).

Allowing a post closing solvency provision to serve as a non-recourse carve-out would virtually eliminate non-recourse lending.<sup>135</sup> For real estate developers, having to document these (now recourse) loans as contingent liabilities on their personal financial statements, will weaken the developers overall financial strength in the eyes of future lenders, and result in the developers finding it more difficult to secure financing for future projects.<sup>136</sup> In addition, many borrowers unwillingness to pledge their personal assets as collateral will keep countless development projects from breaking ground.<sup>137</sup> The lack of development could lead to a lull in overall lending and securitization, decreased tax revenue, and frustrate overall economic environment in the jurisdictions that choose enforce post closing solvency provisions.<sup>138</sup> Further, developers facing personal liability during foreclosure proceedings on what was previously thought to be a non-recourse loan, are likely to challenge the action in court. The CREFC warns of extensive litigation over the definition of non-recourse in commercial mortgages at a great expense of borrowers and lenders.<sup>139</sup>

### **C. Michigan . . . Ohio . . . New Jersey?**

#### **1. Ohio**

In a likely response to the holding in *Cherryland*, and subsequent enactment of the NMLA, Ohio addressed the issue of post closing solvency covenants in loan documents with the

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<sup>135</sup> *Cherryland*, 300 Mich. App. at 375.

<sup>136</sup> *Id.* (referencing the Transcript of *Hearing on S.B. 922 Before the S. Econ. Dev. Comm.*, 12, 14, 18 (Feb. 29, 2012) (recalling the testimony of developers).

<sup>137</sup> *BOMA International Supports Nonrecourse Mortgage Loan Act in Michigan*, YAHOO! FINANCE, (Apr. 18, 2012), <http://finance.yahoo.com/news/boma-international-supports-nonrecourse-mortgage-143900336.html>.

<sup>138</sup> *See Cherryland*, 300 Mich. App. at 375; Brief of the CRE Finance Council as Amicus Curiae, at 126, *Wells Fargo, N.A. v. Cherryland Ltd. P'ship*, 295 Mich. App. 99 (Mich. Ct. App. 2011) (No. 304682).

<sup>139</sup> Brief of the CRE Finance Council as Amicus Curiae, at 126, *Wells Fargo, N.A. v. Cherryland Ltd. P'ship*, 295 Mich. App. 99 (Mich. Ct. App. 2011) (No. 304682).

March 27, 2013 enactment of the Ohio Legacy Trust Act (“the Act”).<sup>140</sup> The language of the Act is nearly identical to that of Michigan’s NMLA passed just one year earlier.<sup>141</sup> Section 1319.08(A) of the Ohio Legacy Trust Act states that “[a] postclosing solvency covenant shall not be used, directly or indirectly, as a nonrecourse carveout or as the basis for any claim or action against a borrower or any guarantor or other surety on a nonrecourse loan.”<sup>142</sup> Section (B) of the Act states that any “provision in the documents for a nonrecourse loan that does not comply with division (A) of this section is invalid and unenforceable.”<sup>143</sup>

## 2. New Jersey

Unlike Michigan and Ohio, New Jersey does not yet have legislation equivalent to that of the NMLA.<sup>144</sup> While New Jersey courts have never reported a decision regarding the enforcement of a post closing solvency covenant, the Superior Court of New Jersey, Appellate Division, did decide a closely related case in *CSFB 2001-CP-4 Princeton Park Corp. Ctr. v. SB Rental I*.<sup>145</sup>

In *Princeton Park*, the defendants received a \$13.3 million non-recourse loan from Credit Suisse First Boston Mortgage Capital, LLC (“CSFB” or “plaintiff”) in May of 2001.<sup>146</sup> The mortgage agreement, among other non-recourse carve-outs, contained a provision barring subordinate financing without CSFB’s written consent.<sup>147</sup> In May of 2004, defendants obtained subordinate financing in the amount of \$400,000 without obtaining written consent.<sup>148</sup> Seven

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<sup>140</sup> OHIO REV. CODE. ANN. §§1319.07-1319.09 (LexisNexis 2013).

<sup>141</sup> Compare MICH. COMP. LAWS SERV. §§445.1593-4 with OHIO REV. CODE. ANN. §1319.08.

<sup>142</sup> OHIO REV. CODE. ANN. §§1319.08.

<sup>143</sup> *Id.*

<sup>144</sup> Russel Bershada, ‘Bad-Boy’ Guaranty Gets a Surprising Interpretation, N.J.L.J. (May 31, 2013), <http://www.law.com/jsp/nj/PubArticleNJ.jsp?id=1202602371462>.

<sup>145</sup> See *CSFB 2001-CP-4 Princeton Park Corp. Ctr. v. SB Rental I*, 410 N.J. Super. 114 (App. Div. 2009).

<sup>146</sup> *Princeton Park*, 410 N.J. Super. at 117.

<sup>147</sup> *Id.* at 118.

<sup>148</sup> *Id.*

months later, the defendants had satisfied the \$400,000 lien.<sup>149</sup> Defendants subsequently lost the sole tenant of their building, and in May 2006 failed to make its mortgage payment to the CSFB, who shortly thereafter filed a foreclosure action.<sup>150</sup> Summary judgment was granted in March of 2007, and the property was later sold at a sheriff's sale.<sup>151</sup>

Plaintiff subsequently filed this action against the borrower and guarantors personally, “seeking recovery of the deficiency on the balance of the May . . . 2001 mortgage note, reduced by the proceeds of the sheriff's sale.”<sup>152</sup> Plaintiffs here sought full recourse liability against the guarantors based on their breach of the subordinate financing covenant in 2004.<sup>153</sup> Despite defendant's arguments that the subordinate financing was satisfied two years prior to their non-payment, and breach of that covenant was unrelated to any damages to the plaintiff, the court ultimately found for the plaintiffs.<sup>154</sup> “Having freely and knowingly negotiated for the benefit of avoiding recourse liability . . . and agreeing to the burden of full recourse liability in certain specified circumstances, defendants may not now escape the consequences of their bargain.”<sup>155</sup>

The holding *Princeton Park* is similar to those in *Mobile Hotel Props.* and *Blue Hills Office Park* in that each court strictly construed the non-recourse carve-out provisions in the loan documents.<sup>156</sup> Considering the both the precedent and persuasive authority for strict enforcement of carve-out provisions it can be inferred that if faced with a dispute similar to that in *Cherryland*, a New Jersey court will most likely strictly construe the loan documents, and enforce a post closing solvency provision if it should appear to have been breached. Can we

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<sup>149</sup> *Id.*

<sup>150</sup> *Id.*

<sup>151</sup> *Id.*

<sup>152</sup> *Princeton Park*, 410 N.J. Super. at 118.

<sup>153</sup> *Id.* at 118-19.

<sup>154</sup> *Id.* at 124.

<sup>155</sup> *Id.*

<sup>156</sup> Compare *Princeton Park*, 410 N.J. Super. at 118, with *Blue Hills Office Park*, 477 F. Supp. 2d at 382-83, and *Mobile Hotel Props.*, 367 F. Supp. 2d. at 1029.

blame them?

Should the New Jersey judiciary need to be familiar with the regular business practices of highly sophisticated commercial loans? Should they be able to distinguish the rather technical differences between a non-recourse carve-out preventing subordinate financing, and one requiring continued solvency of the borrowing entity? While these concepts may be clear to real estate owners, developers, lenders, and other industry professionals, should our judiciary really be required to have this specialized knowledge? In my opinion, they should not.

“The judiciary . . . is designed to accomplish the discrete task of resolving disputes, typically between two parties, each in pursuit of the party’s own narrow interests.”<sup>157</sup> They are “limited to one set of facts in each lawsuit, which is shaped and limited by arguments from opposing counsel . . . seek[ing] purely private interests.”<sup>158</sup> The court does not “generally consider the views of nonparties on questions of policy, and . . . are limited to the record developed.”<sup>159</sup>

If New Jersey does not pass similar legislation to the NMLA, it is likely that the New Jersey judiciary will continue to strictly enforce post closing solvency provision in the future.<sup>160</sup> Enacting legislation will help avoid the needless expense of subsequent litigation, and possibly prevent similar the economic distress that was forecasted to occur in Michigan prior to the enactment of the NMLA.<sup>161</sup>

#### **IV. CONCLUSION**

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<sup>157</sup> Woodman v. Kera LLC, 486 Mich. 228, 246-47 (Mich. 2010).

<sup>158</sup> *Id.* (citations omitted).

<sup>159</sup> *Id.*

<sup>160</sup> Russel Bershad, ‘Bad-Boy’ Guaranty Gets a Surprising Interpretation, N.J.L.J. (May 31, 2013), <http://www.law.com/jsp/nj/PubArticleNJ.jsp?id=1202602371462>.

<sup>161</sup> Cherryland, 295 Mich. App. 99, at 106

New Jersey should pass legislation similar to Michigan's NMLA. As did the Michigan judiciary, the New Jersey courts have demonstrated that they adopt a "strict enforcement" approach regarding any type of covenant acting as a non-recourse carve-out. The courts have not been receptive to public policy arguments, nor have they exercised their powers of equity to find the provisions in question invalid. In order to prevent the cost of extensive litigation over these types of provisions, New Jersey should heed the warnings of real estate industry professionals, and enact legislation barring the enforcement of post closing solvency covenants as non-recourse carve outs in all existing and future loan documents.