NEGOTIATING DEED OF TRUST LIABILITY AND CARVE OUT CLAUSES

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Biographical Sketch

J. Cary Barton is a graduate of Baylor University (B.A. 1962) and Harvard Law School (LL.B. 1965) and was admitted to the State Bar of Texas in 1965. He worked for the Federal Power Commission and the U.S. Tax Court in Washington, D.C., for several years following his graduation from law school and served in the United States Air Force during the U.S.S. Pueblo crisis in Korea. He has been engaged in the private practice of law in Texas since 1969. He is currently a partner in Barton, Schneider & East, L.L.P., a nine-lawyer firm in San Antonio, Texas, that was founded in 1993. He is Board Certified in Commercial Real Estate Law by the Texas Board of Legal Specialization and his law practice consists primarily of representing real estate developers in commercial real estate transactions. Mr. Barton is a member of the Real Estate Forms Committee of the State Bar of Texas, the Council of the Real Estate, Probate and Trust Law Section of the State Bar of Texas, the Texas College of Real Estate Attorneys and the American College of Real Estate Lawyers. He is listed in The Best Lawyers in America (Real Estate) and was selected as a Texas Super Lawyer 2003-2005 by Texas Monthly and Law & Politics Magazine. He was listed as one of "San Antonio's Best Attorneys" in Scene in SA Monthly in August, 2004 and 2005. Mr. Barton received the fourth annual lifetime achievement award for contributions by a distinguished Texas real estate lawyer from the Real Estate, Probate and Trust Law Section of the State Bar of Texas in 2003. He received the Best Speaker Award for the 2004 Advanced Real Estate Law Course of the State Bar of Texas for his presentation entitled "Feasibility Issues/Can I Do the Deal?" He is the author of Texas Practice Guide: Business Entities, Volumes 1-4 (Thomson-West, 2005). He was recently appointed to the Commission of the Texas Board of Legal Specialization which prepares the annual examinations for board certification of real estate legal assistants. Mr. Barton has made numerous presentations to lawyers and other professional groups pertaining to commercial real estate financing issues and related subjects.

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APPENDIX A

DEED OF TRUST LIABILITY AND CARVE-OUT CLAUSES

I. INTRODUCTION

This presentation discusses various aspects of provisions in deeds of trust that deal with recourse versus non-recourse liabilities and so-called carve-out provisions imposing liability in an otherwise non-recourse context. A sample non-recourse carve-out provision is attached as Appendix A, but there is a great variety of provisions which lenders and borrowers negotiate on a regular basis.

It should be noted that the author represents borrowers and guarantors almost exclusively. Consequently, although an effort has been made to be relatively even-handed in discussing particular issues in this presentation, the following remarks inevitably reflect the author's perspective.

II. CATEGORIES OP LIABILITY

A. Full Recourse Liability

In Texas, unless otherwise agreed by the parties, a borrower's obligations under instruments evidencing and securing loans are fully recourse. Consequently, it is not necessary for the loan documents for a Texas loan to contain language such as "this is a recourse loan" in order for that characterization to be effective. See, Seaborg Jackson v. Beverly Hills Savings, 753 S. W.2d 242 (Tex.App.--Dallas 1988). In California, on the other hand, real estate loans are generally non-recourse and the creditor may not obtain a deficiency judgment after foreclosure. See, California Code of Civil Procedure, Sections 580a-580d.

The recourse liability of a borrower in Texas extends to both the obligation to repay the loan and the obligation to perform the covenants in the instruments securing the loan, unless otherwise agreed by the parties. Prior to the late 1970s, real estate loans were almost universally recourse liabilities of both the borrowers and their principals who were expected to personally guarantee the loans.

B. Full Non-Recourse Liability

The concept of non-recourse liability for Texas real estate loans began to emerge in the late 1970s and early 1980s as the result of a federal income tax provision. That provision allowed limited partners to include their share of non-recourse partnership liabilities in their tax basis in their limited partnership interests. Being able to include those amounts in the basis of their partnership interests permitted the limited partners to obtain tax deductions exceeding their equity capital contributions to the partnerships. Although lenders were reluctant at first to provide loans on a non-recourse basis, the forces of competition and the compelling nature of the favorable tax treatment eventually overcame that reluctance. After a time, the entire community of lenders and developers came to view non-recourse financing as a more or less routine way of doing business, as long as there was sufficient perceived equity or front-end cash investment in a project. The Tax Reform Act of 1986 eliminated most of the tax benefits of this investment structure for typical private investors, but the rules remain the same for commercial interests. Moreover, the idea that real estate financing could never be non-recourse to any extent had been overcome and variations on the degree of recourse liability which exists in particular circumstances continue to the current day.

The early non-recourse provisions in loan documents were sketchy and it was not clear whether they applied to both the obligation to repay the loan and the obligation to perform the covenants in the security instruments. Eventually, the courts determined that a non-recourse provision in a promissory note also protected a borrower from liability for paying ad valorem taxes that the lender had to pay after a foreclosure. Smart v. Tower Land and Inv. Co., 597 S.W.2d 333 (Tex. 1980). In the meantime, careful legal counsel for borrowers had begun to request that the loan documents be modified to make absolutely clear that both sets of obligations were non-recourse and that was the common state of affairs by the mid-1980s.

C. Non-recourse Liability with Carve-outs

During the real estate financing debacle of the late 1980s, lenders began to realize that borrowers were abusing non-recourse provisions related to covenants in the security instruments. For example, borrowers were using the rents on mortgaged properties to finance litigation against the lenders and bankruptcy proceedings with no liability exposure for such actions. Lenders then began to distinguish between a non-recourse obligation for the payment of the principal and interest of a loan and a recourse obligation for the performance of the covenants in the instruments securing the loans. That process eventually led to the development of so-called "bad boy" provisions which were intended to prevent borrowers from abusing the system by imposing recourse liability on the borrowers and their guarantors for specified acts taken in connection with an otherwise non-recourse loan. The list of carve-out provisions has grown considerably in the years since that time and recently has begun to include provisions that may undermine completely the very nature of non-recourse liability for the loan itself. The specific aspects of a typical set of non-recourse carve-out provisions are discussed further below.

III. ANALYSIS OF CARVE-OUT PROVISIONS

A. General Standard of Liability

A threshold issue which counsel will want to review in examining any set of carve-out provisions is the extent of liability created by the operation of the carve-outs. For example, some carve-out provisions say that a violation of the carve-out restrictions will result in the borrower being fully liable for the loan, while other provisions state that a violation of the carve-out restrictions will produce liability only for the loss caused by the violation. Some provisions, such as the one attached as Appendix A, include both such approaches, so that some violations create full liability and other violations create only partial liability. Counsel for a borrower will want to limit the effects of violations to the direct loss caused to the maximum extent possible, of course, but lenders will usually want to provide for full liability for at least some violations, such as full liability for the guarantor in the event of the borrower's bankruptcy, as discussed further below.

B. Fraud and Misrepresentation

The original and still classic "bad boy" carve-out is for fraud and misrepresentation by the borrower. Some provisions state that such actions will result in full recourse liability and others say that they will result in only partial liability for the losses caused. One could conceivably argue for a broader liability with respect to fraud that induced the lender to make the loan in the first place and a more narrow liability with respect to fraud occurring during the term of the loan. The borrower's counsel should endeavor to limit such provisions to circumstances where statements made by the borrower were untrue in a material respect when made and not to leave open the possibility that the borrower becomes liable on a recourse basis because of later events.

C. Failure to Pay Taxes and Insurance

Lenders justifiably view a borrower's failure to pay ad valorem taxes, insurance premiums, assessments and other obligations creating liens against the property as serious matters and want the borrower and guarantor to be fully liable for any loss caused by such failure. Since the lender's liens are subordinate to the liens securing ad valorem taxes, the lender absolutely wants the taxes to be paid. Similarly, since the improvements on the property are a vital part of the security for the loan, the lender absolutely wants the premiums on the insurance for those improvements to be paid. The other debts cited can have similar adverse consequences. One suggested modification which a borrower's counsel might want to request in such a provision is to limit the recourse liability for ad valorem taxes to the taxes which are attributable to the borrower's period of ownership of the property.

D. Misapplication of Insurance or Condemnation Proceeds

Lenders do not want borrowers to collect insurance or condemnation proceeds and abscond with those proceeds before the loan is repaid. Having a burned-down or condemned property as the collateral for the loan without having those proceeds is simply not a tenable (or tolerable) position for the lender.

E. Misapplication of Rents and Other Income

As noted earlier, in the late 1980s and early 1990s, some borrowers were defaulting on their loans and then using the rents and other income from the properties to finance litigation against their lenders and bankruptcy proceedings. Eventually, the carve-out provisions expanded to impose liability on the borrowers and guarantors for any such funds which were misapplied by the borrower. Occasionally, one will see such a provision which permits the income to be applied only to the debt service on the loan and counsel for the borrower will need to be vigilant to be sure that the income can also be used to operate and maintain the mortgaged property.

F. Failure to Maintain or Restore the Mortgaged Property

Again, since the value of the improvements comprising part of the mortgaged property is the principal security for the loan, the lender wants those improvements to be maintained and to be repaired and restored in the event of any casualty. It needs to be made clear that the borrower is not personally liable for restoring the improvements after a casualty to the extent that the lender requires the insurance proceeds to be applied to the loan instead of being made available for rebuilding. There is some potential room for argument about what constitutes adequate maintenance of the mortgaged property and counsel for the borrower might want to limit such a provision to a failure of maintenance which constitutes waste.

G. Failure to Deliver Advance Rentals and Security Deposits to the Lender

Lenders discovered instances where the borrowers had collected advance rentals and security deposits prior to foreclosure and had not delivered those funds to the lenders and the tenants demanded credit or reimbursement for those amounts after foreclosure. This type of provision was then added to the list of carve-out actions that would produce recourse liability for the borrower and its guarantors. One could make an argument that this liability should not be imposed if the borrower can demonstrate that the advance rentals or security deposits were actually used to pay debt service on the loan or the expenses of operating and maintaining the mortgaged property. The lender will usually respond that allowing that type of offset for current rent and other income is acceptable because it does not result in a potential liability on the part of the lender to the third-party tenant, which is the case with advance rentals and security deposits.

H. Removal of Personalty

Defaulting borrowers have been known to remove all or substantially all movable personalty before abandoning a mortgaged property for foreclosure notwithstanding that the personalty was subject to security interests securing the loan. Lenders were discovering, therefore, that equipment and other personal property needed to operate the mortgaged property were disappearing and having to be replaced in order to operate the mortgaged property after foreclosure. That resulted in a decision by the lenders that borrowers and guarantors should be personally liable for any such personalty removed from the property and not replaced in the manner required by the security instruments.

I. Environmental Matters

Imposition of recourse liability for environmental obligations is virtually universal in commercial real estate lending today. Nevertheless, counsel for borrowers and guarantors will want to examine the underlying environmental documents in order to determine if the scope of the recourse liability needs to be limited in any manner. For example, many underlying environmental documents do not exclude liability for environmental violations caused by the lender or its agents. Similarly, many underlying environmental documents do not make clear that the borrower's liability does not extend to environmental violations occurring after foreclosure or other disposition of the mortgaged property, even though those documents do make very clear that the obligations under the instruments will survive foreclosure. In these situations, a lender could conceivably argue that it would not have been exposed to the environmental liability if the borrower had not defaulted, so the borrower is liable for the environmental violation arising after the foreclosure even though it was not caused by the borrower.

J. Subordinate Financing

Lenders are constitutionally opposed to subordinate financing on mortgaged property for several reasons. First, the lenders do not want any other secured lenders having class status in a bankruptcy proceeding which might enable the subordinate lenders to interfere with the superior lender's exercise of its rights in the proceeding. Second, the lenders do not want the borrowers to finance out of their equity position in the mortgaged property and be left with little economic incentive to keep the property operating on a solvent basis and to keep the debt service on the primary loan current to avoid losing that equity interest in foreclosure.

K. Transfer of Property or Interest in Borrower

Lenders ordinarily insist on including due-on-sale provisions in security instruments which cover both transfers of interests in the mortgaged property and transfers of interest in the borrowing entity, with some exceptions. Consequently, the likelihood of a transfer of an interest in the property or the borrowing entity without the lender's consent is fairly remote as a practical matter and the lender can always declare the loan in default if the due-on-sale provision is violated. Nevertheless, lenders view such restrictions on the ownership of the mortgaged property and the borrowing entity very seriously and often insist on having a corresponding carve-out provision available as a means of enforcement in addition to the default mechanism in the security instrument. The efforts of the borrower's counsel in this area, therefore, will need to be directed toward negotiating exceptions to the due-on-sale clause, such as a one-time right to sell the mortgaged property without a change in the interest rate or other terms of the loan or a right to transfer a non-controlling interest in the borrowing entity.

L. Litigation Against the Lender

Sometimes, the carve-out provisions include a restriction against instituting litigation against the lender in order to prevent the lender from foreclosing on the mortgaged property unless the borrower is successful in obtaining a judgment for damages or an injunction against the lender. This sort of restriction certainly raises the stakes in deciding whether to seek an injunction against a foreclosure, but that is the whole purpose the lender is trying to achieve.

M. Gross Negligence of Willful Misconduct of the Borrower

The sample carve-out provision which is attached imposes recourse liability for losses sustained by the lender as the result of the gross negligence or willful misconduct of the borrower or its agents. Although not a common provision in the author's experience, it seems difficult to argue against the equity of the lender's position on this issue. Presumably, at least some of this exposure can be covered by insurance, so the borrower will want to explore the extent of protection that can be obtained in that manner.

N. Forfeiture of Property

In recent years, the risks of forfeiture of mortgaged property by reason of criminal violations of drug laws and other penal provisions has increased and become a matter of concern to lenders. The sample carve-out provision which is attached imposes recourse liability for losses due to forfeitures resulting from the criminal acts of the borrower or its agents, affiliates, officers or employees, which does not seem to be unreasonable. This issue can become controversial when a provision of this type is expanded to include a forfeiture of property due to the criminal acts of tenants and a borrower will certainly want to argue that recourse liability should not result from such an event.

O. Waste to Mortgaged Property

The sample carve-out provision which is attached imposes recourse liability for waste to the mortgaged property caused by the acts or omissions of the borrower, its agents, affiliates, officers, employees or contractors. It is not clear what the effect would be of vandalism of the mortgaged property caused by a subcontractor or tenant but the borrower would certainly want to argue that such events are not covered by the sample provision.

P. Attorneys' Fees and Court Costs

Carve-out provisions universally impose recourse liability for attorneys' fees and court costs for which the borrower is liable under the loan documents. Counsel for the borrower will want to examine the loan documents carefully to be sure that it is clear that the lender is entitled to collect reimbursement for its attorneys' fees and court costs in connection with any litigation only if the lender prevails in the proceeding. Some loan document provisions actually say that the lender is entitled to reimbursement whether or not it prevails in the proceeding, although the enforceability of such provisions may be doubtful.

Q. Borrower Bankruptcy Proceedings

One of the earliest types of carve-out provisions dealt with the bankruptcy of the borrower. The lender would argue that it was willing to allow the loan to be non-recourse as long as the borrower did not interfere with the lender's ability to foreclose on the property by filing a bankruptcy proceeding. However, if the borrower went into bankruptcy, then the lender would have the right to seek recourse liability against the guarantor for the full amount of the loan. That pattern is common today.

R. Single-purpose Entity Covenants

The concept of requiring borrowers to be single purpose entities is also related to the bankruptcy law. The idea is that a single-purpose entity can file a Chapter 7 bankruptcy but not a Chapter 11 proceeding, so the lender is not going to be unduly delayed in obtaining possession of the mortgaged property. If, however, the borrower owns multiple assets, a Chapter 11 reorganization proceeding would be possible and the lender may be delayed or prevented from obtaining possession of the mortgaged property while that proceeding is pending. Moreover, even if the borrower is nominally a single-purpose entity but is subject to consolidation with other entities in a Chapter 11 proceeding, the same sort of interference may occur. Lenders began, therefore, to require that single-purpose entity covenants be included in the organizational documents of borrowing entities, all of which were designed to preserve the non-consolidation status of the borrowing entity for bankruptcy purposes. The lenders also expanded the list of non-recourse carve-out provisions to include violations of the single-purpose entity restrictions. Unfortunately, in recent years, the single-purpose entity restrictions have been expanded to include requirements such as assuring that the borrowing entity has adequate capital and is not insolvent. The net effect of those restrictions, combined with the non-recourse carve-out provisions, is that borrowers and guarantors are now being made liable for the very economic risk of the loans for which non-recourse liability was created in the first place. The carve-out provisions which were originally limited to so-called "bad-boy" events have now been pushed full circle around to the pre-1970 atmosphere of full recourse liability. Fortunately, this result is a trap for the unwary in the author's experience and lenders will normally back down from this position when asked to do so. Counsel for borrowers and guarantors should be very vigilant, though, to be sure that this trap does not affect any loan which they review.

IV. CONCLUSION

Non-recourse carve-out provisions have become prevalent and need to be reviewed whenever they exist to be sure that they operate in a manner which is consistent with the business understandings of the principals to the loan transaction.

APPENDIX A

SAMPLE NON-RECOURSE CARVE-OUT PROVISIONS

__. Exculpation Provisions.

(a) Subject to the qualifications below in this paragraph, Borrower shall be liable for payment and performance of all of the obligations, covenants and agreements of Borrower under this Note, the Deed of Trust, the Assignment of Leases and Rents, dated of even date herewith, and executed by Borrower to Lender and all other instruments and documents evidencing, securing or governing the terms of the loan (the "*Loan*") evidenced by this Note (collectively, the "*Loan Documents*"), to the full extent (but only to the extent) of all of the Property and any other items, property or amounts which are collateral or security for the Loan. If a default occurs in the timely and proper payment of any portion of such indebtedness or in the timely performance of any obligations, agreements or covenants under any of the Loan Documents, except as set forth below in this paragraph, neither Borrower, nor any partner or member of Borrower, nor any partner, member, stockholder, manager, director or officer of any partner or member of Borrower, shall be personally liable for the repayment of any of the principal of, interest on, or prepayment fees or late charges, or other charges or fees, due in connection with, the Loan, the performance of any covenants of Borrower under this Note or any of the other Loan Documents or for any deficiency judgment which Lender may obtain after default by Borrower, provided that the foregoing shall in no way limit any liabilities or obligations of any guarantor, indemnitor or other person or entity party to any guaranty, indemnity or other Loan Document under the provisions of the guaranty, indemnity or other Loan Document to which such person or entity is a party, including without limitation the obligations and liabilities of the Borrower and any other Indemnitor under the Environmental Indemnity Agreement (herein so called), dated of even date herewith, and executed by Borrower and Lender.

(b) Notwithstanding the foregoing provisions of this paragraph or any other agreement, Borrower shall be fully and personally liable for any and all liabilities, costs, losses, damages, expenses or claims (including, without limitation, any reduction in the value of the Property or any other items, property or amounts which are collateral or security for the Loan) suffered or incurred by Lender or Lender's successors or assigns by reason of or in connection with the following:

(1) Any fraud or misrepresentation by Borrower in connection with the Loan, including but not limited to any misrepresentation of Borrower contained in any Loan Document;

(2) Any failure to pay taxes attributable to the period of Borrower's ownership of the Property, insurance premiums (except to the extent that such taxes and insurance premiums are then held by Lender), assessments, charges for labor or materials or other charges that can create liens on any portion of the Property;

(3) Any misapplication of (A) proceeds of insurance covering any portion of the Property, or (B) proceeds of the sale or condemnation of any portion of the Property;

(4) Any failure, after the occurrence of a default under the Loan, to apply rentals (including rentals paid in advance), income, profits, issues and products received by or on behalf of Borrower subsequent to the occurrence of such default to the payment of principal or interest due under this Note or the payment of operating expenses (excluding any operator's, manager's or developer's fee payable to Borrower or any affiliate of Borrower) of the Property;

(5) Any failure to maintain, repair or restore the Property in accordance with any Loan Document, to the extent not covered by insurance proceeds paid on account of damage which is the subject of any such repair or restoration which are made available for such purpose to Lender;

(6) Any failure by Borrower to deliver to Lender all unearned advance rentals and security deposits paid by tenants of the Property received by or on behalf of Borrower, and not refunded to or forfeited by such tenants;

(7) Any failure by Borrower to return to, or reimburse Lender for, all personalty taken from the Property by or on behalf of Borrower, except in accordance with the provisions of the Deed of Trust;

(8) Borrower's breach of or failure to pay and perform any and all representations, covenants and indemnities given by Borrower to Lender set forth in the Environmental Indemnity Agreement or any other Loan Document in connection with any environmental matter relating to the Property;

(9) Borrower's failure to obtain Lender's prior written consent to any subordinate financing or any other encumbrance on the Property;

(10) Any transfer of the Property or ownership in Borrower in violation of the terms of the Deed of Trust;

(11) Any litigation or other legal proceeding related to the Loan filed by Borrower or any guarantor or indemnitor that delays or impairs Lender's ability to preserve, enforce or foreclose its lien on the Property, in which action a claim, counterclaim, or defense is asserted against Lender, other than any litigation or other legal proceeding in which a final, non-appealable judgment for money damages or injunctive relief is entered against Lender;

(12) The gross negligence or willful misconduct of Borrower, its agents, affiliates, officers or employees which causes or results in a material diminution, or material loss of value, of the Property that is not reimbursed by insurance or which gross negligence or willful misconduct exposes Lender to claims, liability or costs of defense in any litigation or other legal proceeding;

(13) The seizure or forfeiture of the Property, or any portion thereof, or Lender's interest therein, resulting from criminal wrongdoing by Borrower, its agents, affiliates, officers or employees; or

(14) Waste to the Property caused by the acts or omissions of Borrower, its agents, affiliates, officers, employees or contractors.

(c) Notwithstanding the foregoing provisions of this paragraph or any other agreement, Borrower shall be fully and personally liable for court costs and all attorneys' fees provided for in any Loan Document.

(d) Furthermore, no limitation of liability or recourse provided above in this paragraph shall:

(1) Apply if Borrower shall voluntarily file a petition under Title 11 of the U.S. Code (the "Act"), as such Act may from time to time be amended, or under any similar or successor Federal statute relating to bankruptcy, insolvency, arrangements or reorganizations, or under any state bankruptcy or insolvency act, or file an answer in any involuntary proceeding admitting insolvency or inability to pay debts, or if Borrower shall fail to obtain a vacation or stay of involuntary proceedings brought by any person other than Lender for the reorganization, dissolution or liquidation of Borrower, within one hundred and twenty (120) days of the filing of such involuntary proceeding, or if Borrower shall be adjudged a bankrupt, or if a trustee or receiver shall be appointed for Borrower or Borrower's property, or if the Property shall become subject to the jurisdiction of a Federal bankruptcy court or similar state court, or if Borrower shall make an assignment for the benefit of Borrower's creditors, or if there is an attachment, execution or other judicial seizure of any portion of Borrower's assets and such seizure is not discharged within ten (10) days;

(2) Apply if Borrower shall fail to comply with the terms and provisions of paragraph 25 of the Deed of Trust regarding the maintenance of the single-purpose entity status of Borrower;

(3) Apply if Lender's rights of recourse to the Property are suspended, reduced or impaired by or as a result of any act, omission or misrepresentation of Borrower or any other party now or hereafter liable for any part of the Loan and accrued interest thereon, or by or as a result of any case, action, suit or proceeding to which Borrower or any such other party, voluntarily becomes a party; or

(4) Constitute a waiver, forfeiture, abrogation or limitation of or on any right accorded by any law establishing a debtor relief proceeding, including, but not limited to, Title 11, U.S. Code, which right provides for the assertion in such debtor relief proceeding of a deficiency arising by reason of the insufficiency of collateral notwithstanding an agreement of Lender not to assert such deficiency.