Trend Enforcing Bad Boy Guarantees Continues

By R. Jeffrey Smith

Illinois continues a nationwide trend enforcing "bad boy carve-outs" in non-recourse mortgage loans. The Appellate Court of Illinois recently upheld a "springing guaranty" providing that an otherwise partial loan guaranty would become full recourse to the guarantors if the borrower opposed the lender's exercise of certain of its default remedies.

In *Bank of America, N.A. v. Freed et al*, LaSalle Bank, N.A.[1] made a construction loan in the principal amount of $205 million to Joseph Freed and Associates ("JFA"), secured by a first mortgage on a development project in Chicago. JFA's president, Laurence Freed, and JFA's parent, DDL LLC, were guarantors. The guaranty was limited to $50,325,000, but provided that the limitation would no longer apply if, among other things, "…Borrowers contest, delay or otherwise hinder any action taken by…Lenders in connection with the appointment of a receiver for the Premises or the foreclosure of the [mortgage]."

The loan documents contained the typical construction loan requirement that loan funds remaining to be advanced be kept "in balance" with budgeted completion costs. This was violated almost immediately after closing. Nonetheless, the lender continued to fund for a while as the parties attempted to resolve the issue. Ultimately, the lender initiated judicial foreclosure proceedings, which included a motion for the appointment of a receiver for the project as well as a complaint seeking a judgment against the guarantors for the limited principal amount of $50,325,000. The trial court granted the lender's motion for the appointment of a receiver, and, despite the provisions of the guaranty, the borrower filed an appeal of that appointment. The lender then amended its original complaint to seek a judgment against the guarantors for the full amount of the debt, which was then $206,700,222.39, on the grounds that the appeal fell within the carve-out exception to the guaranty's limitation on liability. The trial court subsequently granted the lender's motion for summary judgment against the guarantors for the full amount of $206,700,222.39. The guarantors appealed the judgment on several grounds.

First, the guarantors argued that the carve-out provision was a vague, ambiguous, overly broad and unenforceable penalty provision. In particular, the guarantors asserted that the provision was ambiguous because it failed "to alert borrowers of precisely what acts will trigger full recourse liability." The Appellate Court quickly found that the borrower's appeal "clearly

1 LaSalle Bank, N.A. subsequently merged with Bank of America, N.A.

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Negotiating the Completion Guaranty: The Guarantor's Perspective

By Thomas C. Klanderman

In recent years, where the typical borrower is a single-purpose entity and the sponsor is providing limited (or no) recourse, most construction lenders will require a credit-worthy entity to back-stop the borrower's obligation to deliver what the lender has bargained for in agreeing to make a construction loan — a completed project to serve as collateral. As a result, completion guarantees have become a standard part of the loan documentation required by lenders making construction loans.

While the scope of a completion guaranty can vary substantially by lender and by loan, the basic parameters of any completion guaranty are generally the same: if the borrower fails to commence, diligently pursue and complete the contemplated project in the manner and within the time provided for in the loan documents, then upon demand by the lender, the guarantor agrees to step in and complete the project, at guarantor's expense, on-time, lien-free, and in accordance with the approved plans and specifications.

When negotiating the term sheet for the loan, most sponsors will readily agree to provide a completion guaranty along the lines described above as a necessary "ticket to ride" in obtaining construction financing. When it comes to the specific terms and conditions of the lender's guaranty document, however, the appropriate scope of the guaranty can involve contentious negotiations. The lender's fundamental goal is to be able to look to the guarantor to complete the project following the borrower's failure to do so. The sophisticated guarantor wants to ensure that the scope of its liabilities and obligations under the completion guaranty is not open-ended or unconditional. The knowledgeable guarantor will make sure that its obligations are limited to a guaranty of the performance of the borrower's obligations in the underlying loan documents, consistent with the original business deal. From the guarantor's perspective, a lender's "standard" form of guaranty can often be overly broad, and without modification can result in an unsatisfactory result for the guarantor that was not bargained for by the lender. This article discusses several issues commonly raised by guarantors in the negotiation of completion guarantees, with this concern in mind.

AVAILABILITY OF LOAN PROCEEDS FOR COMPLETION

The lender's initial draft of a completion guaranty will typically provide that if the guarantor is called upon to complete the project following a borrower default, the guarantor will do so "*at its sole cost and expense*," or words to that effect. In the ordinary course, most guarantors will object to this requirement as overreaching by the lender. From the guarantor's perspective, since the lender has committed to the borrower to fund the loan as and when the borrower constructs the project, if the guarantor is to agree to step into the borrower's shoes and complete, the guarantor should be entitled to the same commitment to fund from the lender. In the absence of this arrangement, the guarantor would be undertaking a commitment greater in scope than the borrower's underlying obligations in the loan documents. The lender would have a lien on a completed project without having funded the loan, resulting in a "windfall" to the lender to which it is not entitled.

Most lenders are receptive to this argument, and will agree that if the guarantor steps in and performs in accordance with the terms and conditions of the loan documents, the lender will continue to fund the loan in accordance with the approved loan budget. If the guarantor is able to satisfy the other conditions for loan advances such that the lender continues to fund, the guarantor's exposure under the completion guaranty for the remaining costs to complete becomes limited to supplying the borrower's unfunded equity contribution requirement, if any, and paying for any cost overruns. With this commitment to fund from the lender, the guarantor should be satisfied as its obligations under the guaranty are consistent with those of the borrower under the loan documents.

As suggested above, however, the lender's agreement to make advances of loan proceeds to the guarantor will not be unconditional, but rather will be contingent upon the guarantor satisfying the conditions to advances set forth in the loan documents. While this is generally acceptable to the guarantor, in particular with respect to requirements relating to the development of the project, the lender's obligation to make advances under the loan documents will also be conditioned on there being no continuing defaults under the loan. Translated to the guaranty, the lender will often seek to

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The Use of Eminent Domain for Underwater Mortgages: Dramatic Implications for Lenders?

By Ellen E. Jamason and Marvin J. Cine

As mortgages continue to be foreclosed and houses abandoned, some local governments are contemplating the use of eminent domain as a solution to reverse the tumultuous slide in the real estate market. Specifically, one proposal—which has gained attention in Nevada and California—calls for local municipalities to condemn through eminent domain proceedings "underwater" mortgage loans (i.e., mortgage loans where the outstanding debt exceeds the value of the property securing the loan). Municipalities would pay lenders an amount considered the "fair-market value" for the mortgages. Ultimately, the municipalities would restructure the mortgages, including reducing the outstanding principal, so that the homeowners could feasibly manage their loan payments going forward.

The concept of using eminent domain to force the restructuring of home mortgage loans has been promoted by academics, such as Cornell Law School Professor Robert Hockett, as well as at least one business organized to implement such a plan—a San Francisco-based fund called Mortgage Resolution Partners (MRP). The county of San Bernardino and the cities of Fontana and Ontario, Calif., formed a joint powers authority in mid-2012 to examine MRP's proposal. Although that joint powers authority recently decided not to pursue the plan, other communities are reportedly considering the idea. Given the importance of the housing market to economic recovery in general, and the novelty of the concept of using eminent domain powers to facilitate the market recovery, it is important to understand the proposal and explore its legal implications.

THE PROPOSAL

Under the proposal, a governmental agency would acquire the loans by eminent domain and transfer them to MRP, which would then restructure the loan terms to make them more affordable to the borrowers. The proposal targets deeply underwater mortgages not yet in default, which are held by private securitization trusts (as opposed to loans owned by banks and government agencies). The theory is that because many of these loans were based on vastly inflated home values established during the real estate "bubble," homeowners have little hope of gaining equity in their homes by paying down their mortgages and are therefore likely to default on those loans. Privately securitized loans are targeted on the theory that those loans are nearly impossible to modify by agreement because they have been bundled in debt instruments that are widely held, there is no existing mechanism to cause the debt holders to make collective decisions, and the trustees and servicers of the debt are not authorized to modify the underlying loan documents.

The Takings Clause of the Fifth Amendment of the United States Constitution provides that private property shall not "be taken for public use, without just compensation." The proposal raises several questions under takings law: (i) Would the taking be for a legitimate public use? (ii) Would just compensation be paid to the current holders of the loans?

PUBLIC USE

The policy goal of the program is to stabilize communities by reducing the risk of default, foreclosure and eviction of homeowners, and ultimately improve the economic vitality and health of the communities.

Economic development has long been recognized as a legitimate "public use" for which a government agency may exercise its power of eminent domain. For example, in the well-known case *Kelo v. City of New London*, 545 U.S. 469 (2005), the Supreme Court upheld the city of New London's condemnation of privately owned real property and transfer to another private owner, for the purpose of implementing a comprehensive redevelopment plan to improve a distressed local economy. Not only was economic development a legitimate purpose, but that purpose was not invalidated by the fact that after condemnation, the property would be transferred to another private party, and not retained in public ownership.

Here, the public purpose is to prevent deterioration of a community, rather than cleaning up an already blighted neighborhood. However, courts have generally deferred to legislative bodies to determine what constitutes a legitimate public purpose, and community stability is certainly within the realm of traditional public interests such as safety and economic growth. The fact that the loans are ultimately

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Buyers Beware: Does the Bona Fide Prospective Purchaser Exemption act as an Environmental Safe Harbor?

By Katherine B. Kimball

THE BFPP DEFENSE

The passage of the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) in 1980 radically changed the liability scheme for the cleanup of contaminated sites; with few exceptions, cleanup liability was imposed on owners and operators (and certain other parties) without regard to fault for creating contaminated conditions. This new regime led to the disuse of many heavily contaminated former industrial properties (known as "brownfields") that were financially impractical to redevelop because of the potential CERCLA liability. In an effort to encourage brownfields redevelopment, Congress amended CERCLA by adding certain limited liability protections for landowners, including the "Bona Fide Prospective Purchaser" (BFPP) defense. These amendments were passed as part of the so-called "Brownfields Amendments" in 2002. The BFPP defense provides that a buyer of a known contaminated property is protected from CERCLA liability for pre-closing releases of hazardous substances whether the contamination is discovered pre- or post-closing if certain requirements are met. The property must be acquired after January 11, 2002, and each of the following elements must be satisfied by a preponderance of the evidence:

1. *Disposal prior to acquisition*: all disposal of hazardous substances occurs before buyer acquires site
2. *Inquiries*: buyer makes "all appropriate inquires" such as conducting a Phase I Environmental Site Assessment
3. *Notices*: buyer provides all legally required notices if new releases are discovered
4. *Care*: buyer exercises appropriate care to stop and prevent releases
5. *Cooperation, assistance and access*: buyer cooperates with parties involved in cleanup
6. *Institutional control*: buyer complies with institutional controls in place at the site
7. *Requests; subpoenas*: buyer complies with requests for information
8. *No affiliation*: buyer is not affiliated with any other person that is potentially liable for response costs at the site

Since the enactment of the Brownfields Amendments, the effectiveness of the BFPP defense has been questioned. It has not proven to be a true guarantee of exemption from CERCLA liability, and buyers still face real risks, partially due to the lack of guidance on how to properly implement the various elements of the defense. Another limitation on the effectiveness of the BFPP defense is its inapplicability to purchasers in stock acquisitions or mergers because the buyer is not "acquiring ownership" of a site as required under the statute.

ASHLEY II

A 2011 decision of U.S. District Court of South Carolina, *Ashley II of Charleston v. PCS Nitrogen*, affirmed by the Fourth Circuit Court of Appeals in April 2013, has further muddied the waters. In particular, the district court in *Ashley II* went through the eight elements listed above and held that the developer in the case had not met its burden and therefore the defense was not available.

The facts that are relevant to the BFPP analysis are as follows: Ashley II of Charleston, LLC (Ashley) is a sophisticated brownfields redevelopment company. Ashley purchased most of a 43-acre parcel of the Columbia Nitrogen Superfund Site located near Charleston, S.C., in 2003 and the remaining small parcel in 2008, with the plan of redeveloping the property into a mixed-use project. The property had historically been used as a fertilizer plant, which resulted in significant arsenic and lead contamination. As part of the acquisition, Ashley released and indemnified certain prior owners. Ashley conducted Phase I Environmental Site Assessments on both parcels, interacted with the Environmental Protection Agency (EPA), fenced the site for security purposes, collected over 450 soil samples to characterize the conditions and even hired an environmental consultant to help satisfy the BFPP requirements. Ashley demolished the remaining structures on the site, but did not remove underground structures, including cement pads, sumps and trenches (a decision that would come to haunt it). In all, Ashley spent approximately $195,000 assessing the environmental conditions at the site and estimated that the cleanup would cost approximately $8-9 million.

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qualifies as contesting the Bank's actions in connection with the appointment of a receiver," and rejected the argument that the carve-out provision was vague or ambiguous.

Second, the guarantors argued that the carve-out provision was unenforceable "because its sole purpose is to secure their performance and that Illinois courts have refused to enforce such provisions in a contract." The guarantors essentially argued that the carve-out clause was a liquidated damages provision that bore no correlation to the actual damages suffered by the lender, noting that the appeal had resulted in a delay in the appointment of a receiver by only one month. The guarantors asserted that this was therefore an unenforceable penalty. The Appellate Court noted that this argument, in this particular context, was a case of first impression in Illinois, and looked to other states' decisions for guidance. The court found a recent New Jersey decision to be particularly helpful. In that case, a lender sought to enforce a carve-out clause that made an otherwise non-recourse mortgage loan fully recourse if, among other things, the borrower obtained subordinate financing secured by the senior lender's collateral. The borrower obtained a $400,000 junior secured mortgage loan without the senior lender's consent. That junior loan was subsequently paid off. Almost 18 months later, the senior mortgage loan went into default, and the lender foreclosed upon its collateral. However, the lender found out about the prohibited junior financing, invoked the carve-out exception and sought a judgment for the $5,195,932.75 deficiency remaining after foreclosure. The defendants apparently did not dispute that the prohibition on junior financing had been violated, but argued that since the prohibited financing had been paid off well before the senior loan's default, the lender had not been damaged. Accordingly, they argued, the carve-out clause was a non-enforceable liquidated damages provision. Both the trial court and appellate court disagreed, noting that "this was a commercial transaction negotiated between business entities with comparable bargaining power." The New Jersey court pointed out that carve-out clauses "are not considered liquidated damages provisions because they operate principally to define the terms and conditions of personal liability, and not to affix probable damages." The court also noted that, in any event, the effect of the clause was only to permit the lender to recover its actual damages, namely the amount outstanding on the loan at the time of the breach. That amount, the New Jersey court noted, was "neither speculative nor incalculable." The New Jersey court essentially said that the borrower had its choice: a full recourse loan, or a non-recourse loan with carve-outs. Having chosen the latter, the borrower was forced to live with the express terms of its loan documents. The *Freed* court felt that this same analysis applied in the instant case.

The *Freed* defendants also argued that the principle established in a recent New York decision should control. In *ING Real Estate Finance (USA) LLC v. Park Avenue Hotel LLC,* the court found that imposing full recourse was disproportionate to the harm caused to the lender by the violation of the underlying carve-out clause. In *ING*, a lender tried to enforce full recourse liability on the basis that a borrower had failed to pay real property taxes, resulting in a tax lien arising on its security. A carve-out clause imposed full recourse liability upon the borrower and several guarantors if the borrower incurred certain indebtedness in violation of the loan documents and such violation was not cured within 30 days after receipt of notice from the lender. However, a separate carve-out clause also imposed full recourse if the borrower incurred any indebtedness secured by the underlying mortgaged property. That clause did not contain any cure provision. The lender commenced foreclosure proceedings after the borrower failed to repay the loan at maturity, and the borrower subsequently failed to pay real estate taxes in the amount of $278,759.20 before the July 1, 2009, due date. The lender quickly amended its foreclosure complaint to add the guarantors, in order to preserve its right to obtain a deficiency judgment. The borrower then paid the taxes on July 19, 2009. This was well within the 30-day cure period under the prior carve-out clause. The lender sought a deficiency judgment against the borrower and guarantors (estimated to be between $45 million – $65 million). The defendants argued that the borrower had cured the violation within the cure period and therefore full recourse should not exist. The lender asserted that it was relying on the second carve-out provision, premised on borrower's incurring debt secured by the mortgaged property, for which no cure right existed. The court concluded that the underlying event was covered under both clauses, only one of which contained a cure right. Noting that New York law required it to interpret an ambiguous clause in a guaranty in favor of the guarantor, the court determined that the carve-out provision with the cure right

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prevailed. In resolving the ambiguity, the court also concluded that the parties could not possibly have intended that failure to pay taxes in such an amount could trigger liability of the magnitude that lender sought to impose, noting that "[a] commercial agreement, of course, should not be interpreted in a commercially unreasonable manner or contrary to the reasonable expectations of the parties" and that with respect to the lender's position, "[s]uch an unlikely outcome could not have been intended by the parties, sophisticated commercial borrowers and lenders aided by competent counsel." The *Freed* court distinguished the *ING* case as being a case based upon contractual interpretation and therefore not applicable.

Finally, the *Freed* defendants argued that the carve-out was an unenforceable restraint on their right to defend themselves and seek due process. The court rejected this argument, citing *Federal Deposit Insurance Corp. v. Prince George Corp.*, decided by the Fourth Circuit Court of Appeals in 1995. There the Fourth Circuit found that the borrower's filing of a bankruptcy petition four days before a scheduled foreclosure sale was included within the scope of a carve-out clause that made a loan fully recourse if "[Lender's] rights of recourse to the property which is then subject to the Mortgage are suspended, reduced or impaired by or as a result of any act, omission or misrepresentation of…" the borrower. The court rejected the borrower's argument that the carve-out clause essentially forced it to waive its statutory right to file for bankruptcy, and was therefore void as against public policy. The court stated that the borrower hadn't waived its right to file for bankruptcy; it merely had agreed to certain consequences if it did file. The *Freed* court concluded that the instant case was analogous to *Federal Deposit Insurance Corp.* and stated, "[as in *Federal Deposit Insurance Corp.*], defendants were not precluded from contesting the appointment of a receiver or filing defenses to the foreclosure action, but by taking those actions they forfeited their exemption from liability for full repayment of the loan."

The *Freed* decision continues the recent trend of courts enforcing clearly written carve-out clauses. At least in a commercial context, the courts appear willing to enforce the bargain struck between lender and borrower. They find the carve-out clause to be an acceptable and enforceable *quid pro quo* for limited recourse. Where, however, the meaning of the clause is unclear or, as in *ING*, may conflict with another carve-out clause, the lender may not receive such hospitable treatment. Further, although in *Freed* the court felt that an interlocutory appeal of the appointment of a receiver fell within the scope of the carve-out provisions, there are many other conceivable actions that a borrower might take having the effect of delaying a lender's exercise of its remedies that could raise more difficult issues. For example, would a borrower's filing of a motion to extend an answer date in a judicial foreclosure proceeding constitute "delay?" A lender should review its carve-out clauses to be sure that they clearly cover the particular actions that it would expect to trigger full recourse. In addition, while no reported decision appears to have squarely faced the issue, lenders may consider modifying carve-out clauses premised upon a borrower's challenging the lender's exercise of remedies by allowing a borrower to challenge an exercise of remedies without incurring full recourse IF the borrower ultimately prevails in its challenge. This might not only be more palatable to a court, but may also shorten the sometimes painful and protracted negotiation of carve-out clauses.

Another lesson to be learned from these decisions is that finding out the specific terms of any "bad boy" guaranty as early as possible is of critical importance to borrowers and guarantors. Borrowers will usually have more success negotiating these provisions at the letter-of-intent or commitment-letter stage rather than later on when refinancing deadlines or other inflexible time constraints may be looming.

Bucking the trends of the courts' enforcement of non-recourse carve-out clauses are laws recently passed in Michigan and Ohio. In response to a decision by the Michigan Court of Appeals in *Wells Fargo Bank NA v. Cherryland Mall Ltd Partnership*, 295 Mich App 99 (2011), which enforced a carve-out clause making a loan fully recourse to a guarantor if the borrower failed to remain solvent, the Michigan legislature passed the Nonrecourse Mortgage Loan Act, 2012 PA 67, MCL 445. 1591 et. seq. (the "NMLA"). The NMLA provides that a post-closing solvency covenant making an otherwise nonrecourse mortgage loan recourse is contrary to public policy and therefore invalid and unenforceable. The NMLA was recently upheld by the Michigan Court of Appeals. The Court applied the NMLA retroactively to strike down the earlier decision in *Cherryland* despite strong arguments by the bank that its application violated the contract clauses of the United States and Michigan constitutions. Ohio subsequently passed a law modeled on the NMLA, the Ohio Legacy Trust Act (Am. Sub. H.B. 479, adding Sections 1319.07, 1319.08 and 1309.09 to the Ohio Revised Code), which became effective on March 27, 2013. <

NEGOTIATING THE COMPLETION GUARANTY, *CONTINUED FROM PAGE 2*

require, before agreeing to make proceeds of the loan available to the guarantor, that the guarantor first cure the borrower defaults that gave rise to the call on the guaranty in the first instance. The guarantor may be willing to accept this condition, but at a minimum should seek to carve out the obligation to cure any defaults that are not capable of cure or which are personal to the borrower, such as the bankruptcy of the borrower, so that the guarantor is not "stuck" without the benefit of the loan proceeds solely due to a default that it is unable to cure.

"ON TIME" COMPLETION

Another common concern raised by the guarantor in the lender's form of guaranty is the requirement that the guarantor provide a guarantee of "on time" completion. The guarantor is likely to have the same principals and construction team as the borrower or, worse yet, may need to bring in a replacement team that will need to be brought up to speed and mobilized. From the guarantor's vantage point, if construction is substantially delayed, whether due to borrower fault, or perhaps more likely due to reasons beyond borrower's control, is there any reason to believe that the guarantor will be able to deliver a completed project any more quickly? The guarantor may be willing and able to guarantee delivery of a completed project, but a guaranty to do so on a particular schedule may be beyond guarantor's control. With this in mind, the guarantor may seek to delete the "on time" requirement from the scope of its guaranty or negotiate a more realistic date for completion.

This argument may only go so far with the lender. Delays in construction inevitably involve additional carry costs (e.g., additional interest expense, taxes, insurance, etc.), which may quickly exceed the costs that the lender has agreed to fund under the approved budget. If the guarantor is unable to deliver the completed project on time, it could nonetheless agree to contribute additional equity to the project to cover the additional costs incurred to complete the project as a result of the delay. From the lender's viewpoint, the additional carry costs are costs that must be incurred to reach completion and, if not provided for in the budget, just like any other cost overrun, and they are therefore properly within the scope of costs to complete for which the guarantor is liable. That is, the "on time" component of the guaranty, if not a guaranty of the construction schedule, is an appropriate guaranty of a component of the loan budget.

Whether lender's position is persuasive to the guarantor may depend on whether the guarantor has otherwise agreed to recourse for carry costs. If it has not, the guarantor may seek to delete the "on time" requirement as a carry guaranty in disguise, and to limit its exposure under the completion guaranty to the direct hard and soft costs of completing construction.

LENDER OPTION TO COMPLETE

As an alternative to requiring performance on the part of the guarantor, many forms of completion guarantees will provide that, at lender's option, the lender may step in to complete the project itself, at the expense of the guarantor. In the first instance, the guarantor will commonly seek to limit this lender right to be available only if the lender has first called upon the guarantor to step in and complete, and the guarantor has failed to do so. As the guaranty will provide that guarantor will be liable for the costs to complete regardless of whether the guarantor or the lender is pursuing completion of the project, in the ordinary course the guarantor will seek to preserve the option to retain control over the progress of construction.

As a practical matter it may be hard to envision many scenarios where a lender would actually choose to exercise the right to step in and manage the complexities of completing a presumably distressed project. Those forms of completion guarantee that contain this lender right, however, generally provide for broad authority on the part of the lender to make changes in the scope and nature of the project following borrower's default, including changes to the plans and specifications, budget and schedule, that on their face could, if exercised, significantly expand the scope of the guarantor's liabilities under the guaranty.

One rationale of the lender for this broad authority is that it could be necessary to permit the lender to maximize the value of its collateral and mitigate damages in the context of what is presumably a failed project, with a borrower that has not performed as promised. From the guarantor's perspective, however, the lender should be entitled only to that which it bargained for with the borrower, i.e., a project constructed in accordance with the previously approved plans, specifications and budget, and should not be able to "improve" its position in hindsight and at the expense of the guarantor.

TENANT IMPROVEMENTS

If the project to be constructed will be occupied by commercial tenants, the parties must consider whether the scope of the completion guaranty includes the build out of tenant space.

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While perhaps not a controversial issue if the parties agree upon the extent of guarantor's liability up front, the lender's standard form of completion guaranty will often require some modification to properly reflect the business deal, in particular where the guarantor's liability does not extend to all tenant improvements that the borrower may agree to perform during the term of the loan. In that regard, the guarantor will often negotiate for its completion guaranty to terminate upon substantial completion of the core and shell of the project, or perhaps within some set period thereafter to allow for the resolution of any claims relating to that portion of the project. The parties may further agree that tenant improvements for leases in place at closing, or perhaps entered into during the initial construction phase, if provided for in the loan budget, also fall within the scope of guarantor's obligations. Generally, however, guarantors will seek to limit their liability under the guaranty to avoid an "automatic" expansion of their liability to cover additional tenant improvements whenever the borrower enters into a new lease. If the borrower (or guarantor) has delivered the project originally bargained for in obtaining the loan, the guarantor's position typically will be that the lender's purpose in requiring the guaranty has been satisfied, and the guarantor's liability under the guaranty should therefore terminate.

CONCLUSION

While by no means an exhaustive discussion of points arising in the negotiation of completion guarantees, this article is intended to illustrate by discussion of a few recurring issues the degree to which the scope of a completion guaranty may vary. With the details of guarantor's obligations rarely being fully negotiated at the term-sheet phase, the parties should take time in the negotiation of the completion guaranty to ensure that its scope properly reflects their mutual understanding of the business deal should the borrower fail to perform. Taking the time to negotiate these provisions carefully will be well worth it and can save the guarantor from a world of trouble if the project does not work out as expected. <

THE USE OF EMINENT DOMAIN, *CONTINUED FROM PAGE 3*

transferred to a private entity—MRP—is not, in itself, fatal. The proposal is therefore likely to meet the constitutional "public use" test.

JUST COMPENSATION: WHAT IS THE VALUE OF AN UNDERWATER PERFORMING MORTGAGE?

Assuming there is a valid public purpose for exercise of eminent domain, the government must pay the property owner just compensation at the time of the taking. Just compensation is intended to make the owners of the property whole from the loss of the property. The common test is "fair market value," which is generally defined as the price that a voluntary buyer would pay to a voluntary seller, without any compulsion to transact.

Under the proposal, the loans would likely be acquired at a price significantly below the face value of the notes; in fact the MRP website indicates the price "will be significantly less than the fair value of the home." MRP notes sales of "troubled loans" in the secondary market occur at a significant discount to the fair value of the home because of the "foreclosure discount;" i.e., the time and cost of acquiring the home by foreclosure.

Note, however, that by definition, MRP will be targeting *performing*, not defaulted loans. The fact that the loan is undersecured is certainly a factor, but so is the interest rate, the term of the loan, performance history and credit of the borrower. Moreover, the proposal does not take into account the extensive costs that would be incurred by the noteholders—the securitization trusts—in separating out individual notes from their securitization package, and appropriately compensating affected bondholders whose security has been reduced.

PRACTICAL VIABILITY

Regardless of whether the MRP proposal would succeed on a constitutional challenge, it seems highly likely to generate significant litigation from opponents. In addition to the constitutional issues discussed above, obstacles may exist under the eminent domain and municipal laws of the applicable states. Whether cities in targeted communities have both the political will and the financial resources to defend such challenges is an open question. Moreover, some fear that the specter of condemnation of mortgage loans may cause mortgage originators to tighten underwriting standards, scrutinize appraisals and require higher down payments. While tighter standards are an appropriate response to the loose underwriting standards of the boom times, will the MRP proposal cause the pendulum to swing too far in the other direction? And, if so, what effect would this have on the housing market, which is just starting to show some signs of recovery? These difficult questions are being debated in town halls as communities struggle to overcome the fallout of the housing crisis. <

BUYERS BEWARE, *CONTINUED FROM PAGE 4*

Ashley filed suit against PCS Nitrogen, Inc. (PCS), a former owner/operator (unrelated to the entity from whom it purchased the property), requesting a declaratory judgment that PCS was liable for all future cleanup costs and for reimbursement of the costs Ashley had incurred to delineate the site conditions. PSC counterclaimed with contribution claims against Ashley and several other former owner/operators that PSC claimed were potentially responsible parties. In response, Ashley asserted the BFPP defense. The district court held that Ashley could not successfully assert the BFPP because it failed to satisfy three of the required elements: (a) No Affiliation; (b) Disposal; and (c) Care.

No Affiliation. The relevant language describing this element of the BFPP defense requires that the buyer prove that it is not potentially liable for response costs at the site through any contractual, corporate or financial relationship (other than a contractual, corporate or financial relationship that is created by the instruments by which title to the facility is conveyed or financed or by a contract for the sale of goods or services). The reasoning of the district court is unclear, but it appears that Ashley became a "potentially liable" party simply by contractually assuming sellers' CERCLA liability through the indemnification provisions included in the site acquisition documents. The court reached this conclusion even though the express language of the BFPP defense provision of the statute carves out relationships created by "instruments by which title to the facility is conveyed." The court also referenced Ashley's efforts to convince EPA not to recover costs from the seller entities Ashley had indemnified stating that this was "just the sort of affiliation Congress intended to discourage."

In September 2011, after the district court's decision in *Ashley II*, EPA issued a guidance document, "Memorandum from the Environmental Protection Agency: Enforcement Discretion Guidance Regarding the Affiliation Language of CERCLA's Bona Fide Prospective Purchaser and Contiguous Property Owner Liability Protections." The guidance specifically states that "EPA generally does not intend to treat certain contractual or financial relationships (e.g., certain types of indemnification or insurance agreements) that are typically created as part of the transfer of title, although perhaps not part of the deed itself, as disqualifying affiliations." The guidance references the *Ashley II* decision, specifically citing the buyer's efforts to "dissuade EPA from taking an enforcement action against the seller." The guidance does not specifically reject or endorse the *Ashley II* decision, but states that EPA will analyze circumstances relating to title transfers on a case-by-case basis. *Ashley II* and the 2011 guidance leave open the question of whether an environmental indemnity will be considered enough to result in a disqualifying "affiliation" under the BFPP defense or if the "No Affiliation" element fails only when the indemnification is coupled with the buyer taking such action with regulators that could be construed as discouraging enforcement against any potentially responsible party.

Disposal. This element requires that all disposal of hazardous substances at the facility occurs before the buyer acquires the facility (meaning there can be no post-closing disposals). *Ashley II* was the first reported decision to interpret "disposal" in the context of the BFPP defense, although it has been heavily litigated for years in other CERCLA contexts (such as determining liability of former owners and operators). Interpretations of "disposal" in these other CERCLA contexts has varied widely from "passive migration" of contamination in soil and/or groundwater constituting disposal to requiring that some "active conduct" take place. The district court in *Ashley II* followed the precedent set by the U.S. Court of Appeals for the Fourth Circuit, which has taken the view that passive migration constitutes post-closing disposal. Arguably, this broad interpretation negates the benefit of the BFPP defense since full remediation of contamination is the only way a buyer can be confident that pre-closing contamination is not passively migrating. The *Ashley II* decision held that post-acquisition "disposals" were likely to have occurred at the property because the underground structures such as the sumps and trenches were left in place instead of being removed or filled. Ashley did address these underground structures about a year after the demolition of the associated buildings, but the court found this was too late. Under this interpretation, a new owner would essentially be required to prove a negative: that no disposals have occurred after acquisition.

Care.This element requires the buyer to exercise appropriate care with respect to hazardous substances found at the facility by taking reasonable steps to (i) stop any continuing release; (ii) prevent any threatened future release; and (iii) prevent or limit human, environmental or natural resource exposure to any previously released hazardous substance. Uncertainty has surrounded what constitutes "reasonable steps" since the Brownfields Amendments were passed in 2002. In March 2003, EPA issued guidance on this topic, "Memorandum from the Environmental Protection Agency: Interim Guidance Regarding Criteria Landowners Must Meet

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in Order to Qualify for Bona Fide Prospective Purchaser, Contiguous Property Owner, or Innocent Landowner Limitations on CERCLA Liability." The guidance states "the reasonable steps determination will be a site-specific, fact based inquiry." Courts have interpreted the scope of what constitutes reasonable steps quite differently; this is understandable since the statutory requirements and even the on-point guidance is vague and provides no real path for buyers looking to qualify for the BFPP defense. In *Ashley II*, the district court held that Ashley should have addressed more of the recommendations in the Phase I reports (Ashley addressed many, but not all issues), in particular the court noted Ashley's failure to promptly clean and fill the sumps, Ashley's failure to keep a debris pile from accumulating over the course of a year and Ashley's failure to maintain crushed rock that was serving as a cap over contaminated areas. The *Ashley II* decision further obscures what constitutes reasonable steps for post-acquisition care of a contaminated property.

APPEAL OF ASHLEY II

On April 4, 2013, the Fourth Circuit Court of Appeals affirmed the decision of the district court. In rejecting the BFPP defense asserted by Ashley, the opinion of the Court focuses on appropriate care, and does not discuss the disposal or affiliation elements of the defense. The opinion states that the standard of "appropriate care" in the BFPP defense is at least as stringent as the "due care" standard mandated elsewhere in CERCLA, and agrees with statements in Second Circuit opinions that the inquiry asks whether a party "took all precautions with respect to the particular waste that a similarly situated reasonable and prudent person would have taken in light of all relevant facts and circumstances." It concludes that under these standards Ashley's inactions with reference to the sumps demonstrate that it did not take reasonable steps to prevent any future release. Because a party must establish all eight elements in order to qualify for the BFPP defense the failure to establish this element was sufficient to deny its protection to Ashley.

CONCLUSION

The uncertainty surrounding the BFPP defense could have far-reaching impacts on the lending market for redevelopment projects. Brownfields developers have been left without much-needed guidance on what it takes to qualify for the BFPP defense. In 2011, ASTM International released E2790-11, a "Standard Guide for Identifying and Complying with Continuing Obligations under CERCLA." The guide outlines suggested procedures for evaluating potential environmental impacts and what steps to take to fulfill continuing obligations. This guide may be a helpful starting point for buyers of contaminated land, but even the guide notes that there are many unsettled legal issues associated with the BFPP defense and that property owners seeking to maintain liability exemption protection should consult with experienced environmental counsel. Hopefully, the Fourth Circuit decision is a first step toward clarifying some of these issues, but the current standards do not provide clear guidelines and the uncertainty is likely to continue until Congress or EPA clarifies the BFPP requirements through amendments to the statute or changes to the corresponding regulations. <

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