

'Bad-Boy' Carveouts Speeding Foreclosures

A lender protection introduced following the S&L debacle of the late 1980s is getting its first real test during the current downturn — and seems to be working so far.

The protection, known as a “bankruptcy carveout,” is designed to prevent defaulted borrowers from delaying foreclosures by filing for bankruptcy. Under the loan provision, a nonrecourse commercial mortgage is automatically converted to full recourse status if a borrower voluntarily files for bankruptcy. That would make the borrower personally liable for the loan amount and authorize the lender to pursue all of the borrower’s assets to gain repayment.

The bankruptcy provision is the most significant of a menu of so-called bad-boy carveouts that lenders added to mortgages to keep foreclosures from dragging on for months or even years. The provisions started to be introduced in the early 1990s, after widespread bankruptcy filings during the S&L crisis delayed foreclosures, compounding the losses suffered by lenders. But because of the long-running bull market, the provisions haven’t had much significance until now.

“In the old days, borrowers could declare bankruptcy and do all kinds of things to keep the lender from foreclosing,” said a longtime special-servicing executive. “The bad-boy carveouts are going to be very useful this year.”

“None of these protections have been tested up to now,” added a securitization attorney. “This year we’re going to see a lot of them put to the test.”

Lenders said that there are already signs that the carveouts are having the intended effect. Several market sources noted that New York developer **Harry Macklowe** surrendered multiple Manhattan properties without a legal fight last year when he was unable to refinance a massive debt package from **Deutsche Bank**.

“If he tried to fight Deutsche Bank by declaring bankruptcy, he was going to be personally liable for all those loans, so being

combative wasn’t an option,” said one lender. Macklowe declined to comment.

An attorney said his firm recently completed several foreclosures in one day “without a single bankruptcy.” The carveout “did its job,” he said.

To be sure, lenders don’t view the provisions as a cure-all. There’s no guarantee that the borrower will have other assets to

seize. “Remember that with the economy as bad as it is now, somebody defaulting on a property loan may already be underwater on all his other assets, too,” one commercial banker said. “I’m not sure what recourse is going to get you in that case.”

“It’s another tool, that’s all,” said an executive for the U.S. office of an overseas bank. “If the stakes get high enough, maybe the borrower will say, ‘Look, here’s some money, take it and leave me alone.’ When a loan goes bad, you want a lot of cards to play.”

The bankruptcy carveout doesn’t apply to involuntary bankruptcies, but lenders are watchful of whether borrowers are engineering phony involuntary filings. “Let’s say the owner of a building has some business relationships connected with the building,” an attorney explained. “He owes them money for some services, so he gets

them to start demanding immediate payment. He announces that he can’t meet the demands, so he declares bankruptcy. Banks get really nasty when they think somebody’s trying to pull something like that.”

In addition to the bankruptcy carveout, lenders have added other protections, said real estate attorney **Joshua Stein**, a partner at **Latham & Watkins**. For example, a loan would convert to recourse status if a borrower improperly uses a building’s cash flow or deliberately neglects upkeep. Likewise, a borrower would be subject to recourse if unforeseen environmental problems crop up. Also, a borrower can be liable if a lender incurs expenses seizing or protecting the value of a property, Stein said. ♦

