Real Estate Review

Summer 1978

VOLUME 8, NO. 2

The Real Estate Institute of New York University

WG&L

What are the limits to limited liability?

People and Property: Mortgage Exculpation Clauses

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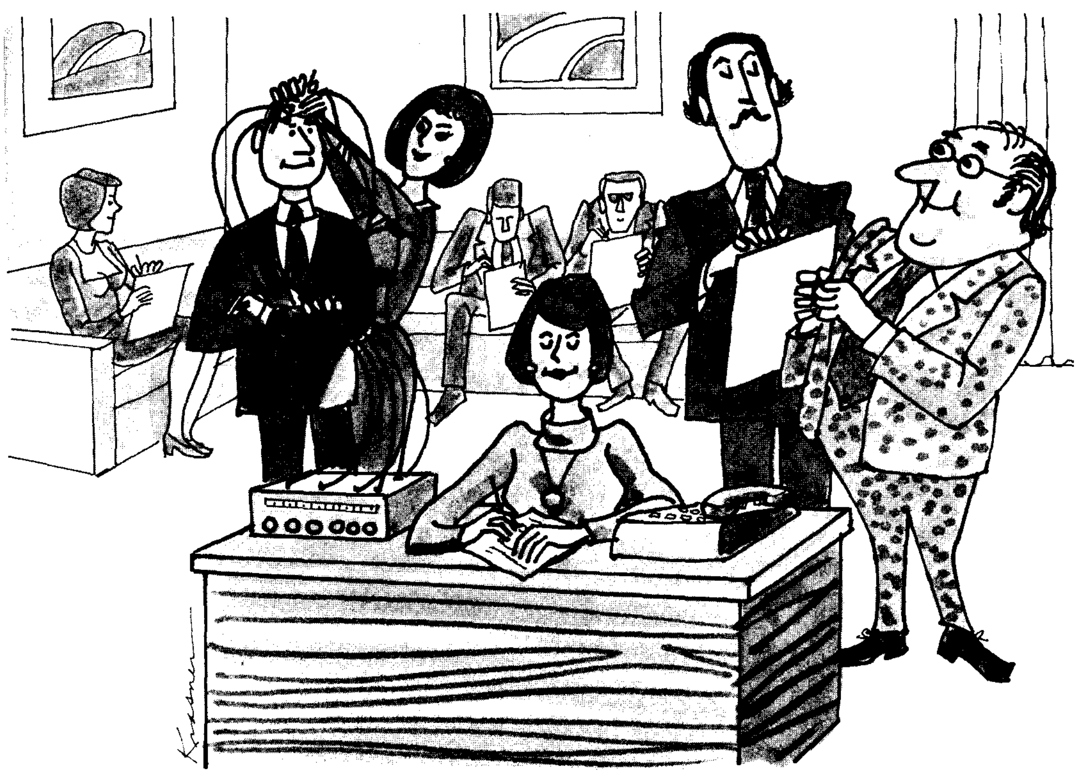

NOW AND THEN, I still hear from my old friend, Dr. Hermann Draykopf. Hermann still presides over that prestigious organization, the International Congress of Psychiatry and Psychology. Over the years, he has taken an interest in the personality structures of such important businessmen as Harry Paine, Nick Tromba, Brent V. Firestone, and Sal Briccone, Jr.

Recently, Dr. Draykopf wrote to me to advise me about his forthcoming treatise, *The Neurotic and Psychotic Characteristics of American Real Estate Operators as Derived From Handwriting Analysis.* Hermann also told me that he was about to return to the United States accompanied by his brilliant Greek colleague, Dr. Clytemnestra Tsouris.

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They were planning to collect the signatures, handwriting samples, and doodles of real estate moguls and to correlate these samples with personality characteristics. Hermann asked if he and Clytemnestra could accompany me on my travels so that they could gather information. I agreed to pass them off as paraprofessional law clerks.

I probably should have realized that some of our clients would find it strange to see me accompanied everywhere by a plump, 65-year-old, goateed Viennese and a lithe Greek of 25 who looked as if she belonged in *Playboy*.

One day, my appointment was at the law offices of Erisa, Milltown, Stonehead & Grumble. Our client, Brent V. Firestone, Chairman of the Board of the world-famous clothing chain, Wally, Jrs., was about to borrow $4.5 million from Euphoria Real Estate Investment Trust to finance the construction of the biggest industrial park in Yahoo. I arrived at the tower suite offices at 9:15 A.M., fifteen minutes too late to stop the encounter between Drs. Draykopf and Tsouris and the very proper employees.

Dr. Draykopf was getting handwriting samples from messengers, delivery boys, secretaries, and attorneys. Dr. Tsouris, who claims she can discern personality characteristics by measuring electrical brain impulses, was busy wiring people's heads.

I put a stop to this and insisted that they stick to their roles as paraprofessionals and limit their information gathering to external observations of personality.

They put their apparatus away just as J. Chapman Erisa arrived to move us to the conference room to await the arrival of our clients. His client, G. Archer Leland, III, Vice-Chairman of Euphoria Real Estate Investment Trust, and my client, Brent V. Firestone, appeared in short order.

There was only one issue left to negotiate: whether Firestone would be personally liable for the debt secured by the mortgage. As the argument progressed, Dr. Draykopf was fascinated by Firestone and Leland, who spent much of their time doodling while their lawyers postured and screamed.

Erisa was not screaming as effectively as usual. He was fascinated by the bountiful figure of Dr. Clytemnestra Tsouris. Notwithstanding her devotion to science, Dr. Tsouris made no secret of the fact that she enjoyed her interpersonal relationships, as well.

Despite the pleasant distraction, the exculpation dispute raged on interminably. G. Archer Leland, III insisted that Euphoria would not lend money to finance any project unless the developer had sufficient confidence in the project to agree to be personally responsible for the repayment of the debt. Firestone shouted that he would not be intimidated, and that no one was going to have the opportunity of attaching his personal assets as a result of a defaulted mortgage.

Dr. Hermann Draykopf almost blew his disguise as a legal assistant by intervening with soothing therapeutic suggestions. He finally suggested that I take Firestone outside and brief him on the problems we were discussing. Of course, I did so immediately. Here is a summary of what I told Firestone.

DEFINING "EXCULPATION"

"Exculpation" is a strange four-syllable word which real estate people love to mouth. Unfortunately, easily one-half of all real estate operators have no idea of what the word means. Yet the concept of exculpation plays an important role in permanent loan agreements; it constitutes a major negotiating objective in commercial, office, and industrial leases; and it plays a role in almost every real estate contract you can think of.

An exculpation clause is any clause that limits the liability of a party to a mortgage, lease, or contract. In order to understand exculpation clauses in mortgages, it is a good idea to divide mortgages into two categories: those which secure an obligation to repay borrowed money and those which secure the deferred payment of part of the purchase price for property.

EXCULPATION IN BORROWER-MONEY MORTGAGES

Exculpation is important in mortgages that secure the repayment of money borrowed to finance the construction of new buildings or the acquisition of old buildings because the loans are often so large. Unless the borrower's liability is limited, the borrower may lose all of his assets if the project fails.

Furthermore, these mortgages usually secure long-term loans that may exceed the borrower's productive years or even his life expectancy.

If at any time during the term of a permanent loan the underlying real estate decays, a borrower who is an individual or a partnership composed of individuals could be ruined financially unless the borrower is protected by an exculpation clause.

Of course, a borrower could achieve limited liability by holding the property and executing the mortgage in the name of a corporation, but the tax disadvantages of corporate ownership are so great that few investors will consider this alternative.

Major permanent lenders are customarily willing to include exculpation clauses in mortgages. Their decision to lend is usually *not* based on the credit of the borrower. They are concerned with the income-generating power of the project that secures the mortgage, the expenses of operating that project, the nature and length of the leases of the tenants, and the credit of those tenants.

Construction lenders, on the other hand, generally expect their borrowers to be personally responsible to repay what they borrow. Construction lenders customarily refuse to agree to an exculpation clause in their mortgage instruments because the credit of their borrowers is usually a major factor in their decision to lend the money in the first place. The other major factors considered by construction lenders are:

- The borrower's previous construction and development experience;
- The existence of a "takeout" agreement with a permanent lender; and
- The economic viability of the project.

EXCULPATION IN PURCHASE-MONEY MORTGAGES

A real estate investor who buys a new building and pays only partly in cash is naturally reluctant to be personally liable to pay the balance of the purchase price from his own pocket if the property turns out to be a lemon. He knows that the seller will get the property back if the full purchase price is not paid according to the terms of the purchase-money mortgage. But that is easier to swallow than paying the purchase price in full and ending up with a valueless piece of property.

However, not all purchase-money mortgages contain exculpation clauses. In many situations, a seller will not agree to deferred payments unless he has ironclad assurances that the entire purchase price will be paid.

Under the proper circumstances, it may be wise to accept a purchase-money mortgage without an exculpation clause. If the purchaser is willing to pay the whole price in cash at the closing but can arrange for deferred payments, he will not have a strong objection to being liable personally to repay that deferred portion in the future.

MORTGAGE EXCULPATION AND DEPRECIATION

The exculpation clause confers tax benefits on the borrower. As the tax law stands, members of a limited partnership which owns depreciable real estate are entitled to a distributive share of depreciation deductions with respect to that property. The basis from which the partnership calculates depreciation is the purchase price of the property, *including* any mortgage debt which the partnership assumed or any mortgage securing a loan to finance the purchase.

If the mortgages included in the basis for the property contain an exculpation clause, each limited partner may claim his distributive share of depreciation in accordance with the partnership agreement. But if the general partner is personally liable to repay the debt and the limited partners are not, most of the depreciation deductions could end up with the general partner alone. Thus, the amount of the distributive share of depreciation available to a limited partner depends in part on whether or not the general partner has really taken an unlimited risk with respect to any mortgage that is part of the property's tax basis.

DRAFTING THE EXCULPATION CLAUSE

Borrowers would like an exculpation clause to be one under which the lender agrees that the buyer is not "personally liable." Their ideal clause might be worded something like this:

Model Clause 1

> Notwithstanding anything to the contrary, the mortgagor shall not be personally responsible for repayment of the debt secured by this mortgage, and the mortgagor shall not be personally responsible for failure to comply with any of its obligations set forth in this mortgage, the note it secures, or any of the documents executed in connection with this mortgage.

Most lenders would distrust this clause. If the borrower is not *personally* liable for repaying the debt, what kind of liability does the borrower have? If the borrower has no personal liability, can you sue him? Can you recover the security? Some bank attorneys ask whether a borrower who has no personal liability is a borrower at all.

Here is what might be a more appropriate way to treat exculpation:

Model Clause 2

(a) The liability of the mortgagor under this mortgage, the note it secures, or any of the documents executed in connection with this mortgage is hereby strictly limited to the interest of the mortgagor in the mortgaged premises and the leases assigned to the mortgagor pursuant to the assignment of leases executed in connection with this mortgage.

(b) The mortgagor shall be completely relieved of all liability under this mortgage, the note and the other aforesaid documents upon sale of the mortgaged premises pursuant to foreclosure, upon a bona fide sale of the mortgaged premises to an unrelated third party subject to the limitation of liability in subsection (a), and upon conveyance of the mortgaged premises to mortgagee.

(c) Mortgagee reserves the right to bring any legal or equitable actions or proceedings to recover the security if the debt is not paid in accordance with this mortgage, and these actions may include foreclosure proceedings.

(d) Any judgment in favor of mortgagee shall be satisfied only against the security and may not be satisfied against any other asset of mortgagor, or any successor owner of the mortgaged premises.

(e) Any such judgment shall set forth the language of subsections (a), (b), and (d).

Clause 2 establishes clearly that the borrower *can* be sued and that the lender *can* recover the security.

It also clarifies a few things for the borrower. The borrower is relieved of liability in case things go bad. He does not have to rely on the obscure notion of "no personal liability" to know that his personal assets are not subject to satisfaction, and that should give him comfort.

Some lenders think it still gives him too much comfort. Bitter experience tells them that it permits the dastardly scenario described below.

A permanent lender loans $10 million to a real estate developer to finance a new apartment building. The mortgage contains exculpation Model Clause 1 or 2. The building is fully rented with annual gross rentals of $2.3 million. Annual mortgage payments are $1 million and annual expenses, including real estate taxes and management, are $1.1 million.

As long as things go well for the building, everybody is happy. The developer takes home $200,000 a year, which is more than most of us earn in two years. But, when the rent roll drops just a bit and expenses rise just a bit, the developer discovers that there is nothing left in the deal for him. That is, there would be nothing left for the developer unless he takes immediate action to protect his interests.

And what he can do to protect his interests is to stop paying his lender, stop paying his real estate taxes, and stop paying his utility bills. By making these dynamic moves, he can easily put $500,000, maybe $1 million, into his pocket before the lender wakes up and takes action to recover the security.

What the developer is doing is milking the building. During the milking period, the owner is not likely to spend much money on repairs. He is also likely to skimp on heat and other services.

When the lender finally begins a foreclosure action and gets a receiver appointed, the lender incurs attorney's fees and other expenses. Since the building was not making any money at all before the receivership began, the cost of the receivership probably comes out of the lender's pocket.

Because the developer is protected by Model Clause 1 or 2, the lender cannot put his hands on the borrower's bank account, which has been fattened by the income from the property and by the borrower's refusal to pay for the expenses of the property. Under either clause, the lender has no right to the rent being paid by the occupants of the property until a receiver is appointed.

Three relatively simple mortgage clauses would protect the lender against the use of the exculpation clause as a tool to permit a mortgaged property to be milked.

☐ In multitenanted projects, the lender can insist upon a reasonable right to name the managing agent. In single-tenanted properties, the lender could require that rent be paid to the lender; the lender, in turn, would be required to disburse to the borrower the amount by which the rent exceeds the mortgage and escrow payments.

☐ Rents received should be regarded as a trust fund, at least to the extent of the mortgage payments, real estate taxes, and the operating expenses of the property.

☐ The exculpation clause could be drafted so that the borrower is personally liable to pay the mortgage debt, the real estate taxes, and the operating expenses of the property, but only to the extent of the revenue derived from the property. The clause could also provide that the borrower may be relieved of even this liability by conveying the building to the lender.

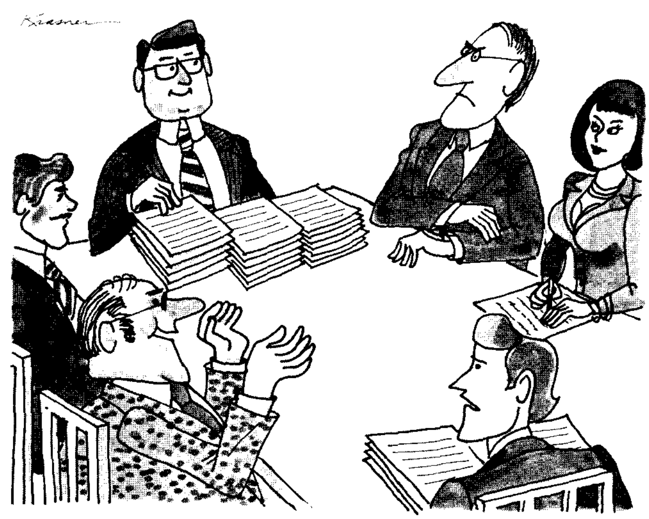
The concept discussed above could be incorporated into the next clause:

Model Clause 3

(a) Mortgagor's liability to pay the principal and interest due with respect to the debt, its liability to pay real estate taxes and assessments imposed against the property, its liability to manage, maintain, repair, and operate the property, and its liability to discharge its other obligations under this mortgage are hereby limited to the rents, issues, and profits of the property to the extent received by or on behalf of mortgagor.

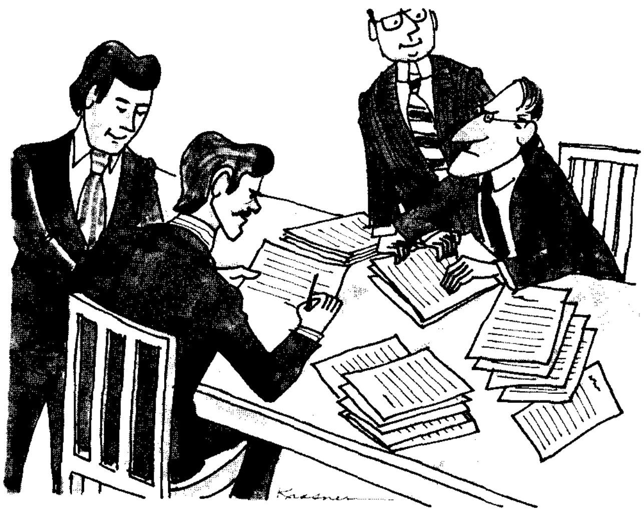
(b) References to liability under this mortgage shall extend to liability under the note secured by this mortgage and all documents executed in connection with this mortgage or the note.

(c) If mortgagor shall convey its entire interest in the property to mortgagee or if mortgagor shall make a bona fide conveyance for valuable consideration of its entire interest in the property to another person who assumes mort-



gagor's liability under this mortgage but limited as provided in this section, mortgagor shall be entirely relieved of all liability under this mortgage, except for liability for failure to apply the rents, issues and profits of the property received by or on behalf of mortgagor prior to the conveyance as required by subsection (a).

Any lender who likes this model clause is welcome to adopt it. Be my guest. But do not expect a round of applause from the borrowers. Borrowers will accuse you of being a throwback to Herbert Hoover or Attila the Hun.



But you can persuade them. Go over it word for word. This kind of exculpation still insulates them from economic disaster if the project is not successful. The only part of the joy of owning real estate that the clause can spoil is the dubious privilege of *causing* an economic disaster by grabbing the rent and applying it all to the owner's personal needs.

A PSYCHOLOGICAL BREAKTHROUGH

While I was out of the room with Firestone, Dr. Draykopf was busy taking handwriting samples of G. Archer Leland, III. Then he left the conference room with Leland to interview those who would cooperate. That left J. Chapman Erisa alone with Dr. Clytemnestra Tsouris. That is exactly what Erisa wanted, and, for different reasons, that is what Dr. Tsouris wanted, too.

When Firestone and I returned, we found Erisa's head wired like a switchboard. Dr. Tsouris was sitting on his lap, measuring the electric impulses from his brain and taking his pulse, all in the interest of science.

Finally, everyone assembled, and the parties were able to compromise their differences on the exculpation clause. The signing ritual began.

When J. Chapman Erisa closed a mortgage, he wanted lots of documents signed. First, there were the mortgage, the note, and an assignment of leases. Then, there were estoppel certificates, subordination agreements, tripartite agreements, certificates of cost, certificates of completion, attorneys' opinions, title binders, corporate resolutions, every document any of you could think of, and quite a few documents none of you could think of.

In all, we were told to sign fifty-six documents, and each document, except two, had to be signed ten times. That made about 560 signatures for all concerned.

Firestone and Leland began to sign immediately. Their right hands moved rhythmically and efficiently across the page.

As they signed, Dr. Draykopf gave us some of his conclusions about what you can learn from the signature of a real estate executive:

(1) As an executive climbs the ladder of success, he deliberately contracts the loops of his os, cs, ms, ns, and gs.
(2) The ultimate sign of power and wealth in real estate is a signature that cannot be recognized even by the signatory.
(3) Excessively neat handwritings are narcissistic and indicate an infantile attachment to a parent figure of the opposite sex.
(4) The net after-tax income of a real estate executive varies in inverse proportion to the legibility of his handwriting.