STATE OF MICHIGAN
SUPREME COURT

WELLS FARGO BANK, N.A., successor by merger to Wells Fargo Bank Minnesota, N.A., as trustee for the registered holders of GMAC Commercial Mortgage Securities, Inc., Mortgage Pass-Through Certificates, Series 2002-C3, by and through Berkadia Commercial Mortgage LLC, its special servicer,

Plaintiff-Appellee,

v

CHERRYLAND MALL LIMITED PARTNERSHIP, a Michigan limited partnership, and DAVID SCHOSTAK, an individual, jointly and severally,

Defendants-Appellants.

Supreme Court No. 144578

Court of Appeals No. 304682

Grand Traverse Circuit Court No. 10-28149-CH

BRIEF OF CRE FINANCE COUNCIL AS *AMICUS CURIAE*

Jamie B. Beaber (P63576)
Scott A. Sinder (*Pro Hac Vice* Application Pending)
Kathryn J. Gainey (*Pro Hac Vice* Application Pending)
STEPTOE & JOHNSON LLP
1330 Connecticut Avenue, N.W.
Washington, DC 20036
Telephone: (202) 429-3000

Attorneys for *Amicus Curiae*
CRE Finance Council

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CRE Finance Council ("CREFC"), by its undersigned counsel, respectfully files the Motion for Leave to file Brief of CRE Finance Council as *Amicus Curiae* and Brief of CRE Finance Counsel as *Amicus Curiae*. This case presents an issue of first impression – whether a borrower in a non-recourse commercial mortgage-backed securities ("CMBS") loan must remain solvent to retain its status as a "single purpose entity" ("SPE"). The loan documents were silent on this question. Although the court below considered two sources of extrinsic evidence, the sources did not support the ultimate decision, and the court did not consider industry practice. The court held that a borrower's insolvency constitutes a failure to maintain its SPE status and triggers recourse liability for the borrower and guarantor for the remaining loan deficiency, even though the loan was non-recourse.

CREFC supports the analysis in the Brief of Attorney General Bill Schuette as *Amicus Curiae* in Support of Defendants' Application for Leave To Appeal ("Attorney General's *Amicus* Br."). *See* Attorney General's *Amicus* Br. at 13, 15-16 (filed Feb. 27, 2012). CREFC's brief focuses on the industry practice concerning the non-recourse protection that is at the heart of a CMBS loan. Such industry practice should guide a court's interpretation of undefined terms in CMBS loan documents. Instead of following industry practice, the court below adopted an interpretation that fundamentally is at odds with any non-recourse protection. Of course the non-recourse right is not absolute, and there is a narrow range of exceptions, as defined by the limited recourse provisions. The decision below, if allowed to stand, conflicts with industry practice, which recognizes a narrow range of exceptions, and renders any non-recourse provision meaningless because

the purpose of the non-recourse right is to protect the borrower or owner if the SPE becomes insolvent. Indeed, the court below acknowledged the significant potential impact of its decision on the CMBS industry because "no cases . . . have held that insolvency is a violation of SPE status," and its "interpretation seems incongruent with the perceived nature of a nonrecourse debt." *Wells Fargo Bank, NA v. Cherryland Mall Ltd. P'ship, et al.*, No. 304682, slip op. at 12, 16 (Mich. Ct. App. Dec. 27, 2011) (per curiam) ("Slip op.").

CREFC has particular insight to offer because the court below relied upon CREFC's previous *amicus* brief as one of two sources of extrinsic evidence to "determine the trade definition for 'single purpose entity.'"[1] CREFC's New York *amicus* brief also is discussed extensively in the decision below, as well as in the Attorney General's *Amicus* Brief. Slip op. at 1-4, 11; Attorney General's *Amicus* Br. at 13-15. Finally, this *amicus* brief is not being submitted in support of either Appellants' Application for Leave To Appeal or Appellee's Brief in Opposition.

INTERESTS OF THE *AMICUS CURIAE*

CREFC is the international trade association for the entire commercial real estate capital finance marketplace, including CMBS. CREFC represents all of the commercial

[1] Slip op. at 11 (citing Amended Brief of *Amici Curiae* Commercial Mortgage Securities Association & Mortgage Bankers Association, filed in *In re Gen. Growth Props., Inc.*, 409 B.R. 43 (Bankr. S.D.N.Y. 2009) ("CREFC NY *Amicus* Brief")). In 2010, Commercial Mortgage Securities Association ("CMSA") changed its name to CRE Finance Council.

real-estate lending industry participants, except the borrowers, that actively are engaged in commercial real estate capital finance activities, including the following:

- lenders who make both portfolio and CMBS-eligible loans;
- issuers (also sometimes known as "securitizers") who package the loans into pools that collateralize bond issuances and that are placed into real estate mortgage investment conduit ("REMIC") trusts for the benefit of investors;
- investors (including public pension funds) that buy CMBS bonds;
- trustees that administer CMBS trusts on behalf of the investors;
- master servicers that collect loan payments from borrowers and remit them to the trust for distribution to investors and that regularly report on the status of the CMBS loans and the underlying properties to investors;
- special servicers that are charged with loan work outs for distressed and defaulted loans;
- credit rating agencies that rate CMBS bonds; and
- other service providers to the commercial real estate capital finance industry.

The trustee, original lender, issuer, and special servicer who are involved in this case all are CREFC members.

CREFC and its members are the leaders in setting standards and maintaining a favorable investing environment for the vast number of outstanding mortgage-backed securities in issuance in the United States. CREFC is dedicated to promoting the strength and liquidity of the commercial real-estate capital finance market.

The decision below threatens the vitality of the entire CMBS market. Indeed, CMBS loans are based on the concept of non-recourse protection, with narrow exceptions stated in the limited recourse provision. All CMBS loans, and almost all commercial

mortgages that are retained on lender portfolios, are non-recourse, which means that the only rights the lender or trustee have are to the property and the proceeds from the property.[2] Before the 2008 collapse of the capital markets, approximately forty percent of all commercial mortgages were securitized, and some have estimated that as many as eighty percent of all commercial mortgages were securitization eligible (meaning that they satisfied CMBS requirements, including being non-recourse). Over the next five years or so, approximately $600 billion in CMBS loans and another $1.2 trillion in commercial real estate loans held on bank balance sheets are due to mature.[3] One quarter of all commercial and multifamily mortgage debt is held in CMBS and, as of the fourth quarter of 2011, 8.6% of the loans in outstanding CMBS were 60 days or more delinquent, in foreclosure, or the underlying properties already had been foreclosed upon.[4] In addition, borrowers generally will have balloon payment obligations that must be satisfied as the $1.8 trillion in outstanding commercial mortgages mature, and any decision in this case could impact a wide swath of those loans.

The common industry practice embedded in the borrower's non-recourse protection is that a lender will limit recovery to the underlying commercial property if the borrower defaults in exchange for the borrower's keeping that asset "separate" and protected from other financial obligations and avoiding the limited "bad boy" carveouts

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[2] Under a recourse loan, the lender has a secured interest in the underlying property but also has a right to seek any unpaid amounts directly from the borrower.

[3] *See* Morgan Stanley, CMBS Market Insights, *The Dodd-Frank NPR: Implications for CMBS*, at 1 (Apr. 12, 2011).

[4] Trepp and Fitch Report CMBS Delinquency for September, VALUEXPRESS NEWS, Oct. 10, 2011, available at http://valuexpress.wordpress.com/2011/10/10/10-3-11-trepp-and-fitch-report-cmbs-delinquency-for-september.

that are under the borrower's control, such as a voluntary bankruptcy filing. The court below failed to consider the industry practice in the CMBS market, and it instead adopted what the court itself described as a "natural and logical" "interpretation [that] seems incongruent with the perceived nature of nonrecourse debt." Slip op. at 12, 16. Given the current state of the market, the decision below has far-reaching implications. The court below acknowledged that "the documents at issue [in this case] appear to be fairly standardized nationwide. . . ." *Id.* at 16. Indeed, CREFC estimates that ten to fifteen percent of all commercial mortgages that currently are outstanding may have the same embedded contractual term that is at issue in this case: an undefined non-recourse requirement that the borrower maintain the status of the SPE. The decision below, if allowed to stand, could generate extensive litigation over the recourse nature of commercial mortgage loans, imposing significant costs on investors and borrowers alike and discouraging future investment.

SUMMARY OF ARGUMENT

By concluding that a borrower's insolvency triggers recourse liability for the borrower and the guarantor for the remaining deficiency, even though the loan was non-recourse, the court below eviscerated the non-recourse protection contained in the loan at issue. Not only does this decision conflict with industry practice, but it also renders meaningless the non-recourse protection included in the loan, as well as the necessity of including any limited recourse provisions. Industry practice makes clear that non-recourse protections should not be lightly voided because participants in the commercial

capital finance market depend upon non-recourse protection, subject to only narrow exceptions, in CMBS loans.

Rather than consider industry practice, the court below instead applied its "natural and logical" understanding of two sources of extrinsic evidence, but neither source supported the conclusion in the decision below. The court even acknowledged that its decision eviscerates the loan's non-recourse protection and renders any non-recourse provision meaningless. *See* Slip op. at 16 ("We recognize that our interpretation seems incongruent with the perceived nature of a nonrecourse debt and are cognizant of the amici's arguments and calculations that, if accurate, indicate economic disaster for the business community in Michigan."). When a contract is clear, a court should enforce its terms. But when a contract is silent as to the meaning of a technical term of art – as here – the court should not adopt an interpretation that is inconsistent with industry practice.

Lenders and borrowers in the CMBS market are sophisticated entities that are fully capable of adopting provisions that define the range of exceptions to non-recourse protections in CMBS loans. In the absence of a clear contractual provision, however, courts should not interpret undefined or ambiguous terms to expand the narrow range of exceptions where limited recourse provisions apply while overriding non-recourse protections.

ARGUMENT

I. The Court Below Eviscerated The Loan's Non-Recourse Protection And Completely Ignored Industry Practice In Concluding That The SPE's Insolvency Eliminated The Loan's Non-Recourse Protections

In concluding that the SPE's insolvency triggered recourse liability for the borrower and the guarantor, the court below recognized that its "interpretation seems incongruent with the perceived nature of a nonrecourse debt." Slip op. at 16. This is an understatement. The court below's decision goes much further, as it essentially eviscerated the non-recourse protection included in the loan at issue and ignored well-established industry practice regarding the manner in which such non-recourse provisions – and the limited exceptions embedded in those provisions – should be interpreted and applied.

The court's interpretation thus violated the cannon of construction prohibiting an interpretation that renders a provision meaningless. A "cardinal principle of construction" is "that a contract is to be construed as a whole." *Associated Truck Lines, Inc. v. Baer*, 77 N.W.2d 384, 386 (Mich. 1956). Courts therefore must ensure in their contract interpretations "that all its parts are to be harmonized so far as reasonably possible; that every word in it is to be given effect, if possible; and that no part is to be taken as eliminated or stricken by some other part unless such a result is fairly inescapable." *Id.*

Moreover, in accordance with standard industry practice regarding non-recourse protections, the court below should have upheld the non-recourse protections for the borrower and guarantor in the case of a borrower's insolvency because a borrower's

insolvency does not fall within the narrow range of exceptions to the non-recourse right, unless the loan documents expressly state otherwise. The court below should have considered the industry practice regarding non-recourse protection, but it failed to do so. Courts should consider extrinsic evidence, such as industry practice, "to determine the intent of the parties" where "contractual language is ambiguous" or silent. *See In re Smith Trust*, 745 N.W.2d 754, 757-58 (Mich. 2008). Thus, where an undefined contractual term has a specialized usage in a particular industry, the court should interpret the term according to industry usage. *See, e.g., Little Caesar Enters., Inc. v. Royakker*, Docket No. 283810, 2009 WL 1940563, at *10 (Mich. Ct. App. 2009) (unpublished) (Where a contract term is "apparently ambiguous," extrinsic evidence is admissible to show that the term has "a recognized meaning in the trade or business to which the contract relates."); *Moraine Prods., Inc. v. Parke, Davis & Co.*, 203 N.W.2d 917, 919 (Mich. Ct. App. 1972) ("[W]here a new and unusual word or phrase is used in a written instrument, or where a word or phrase is used in a peculiar sense as applicable to a particular trade, business, or calling or to any particular class of people, it is proper to receive extrinsic evidence to explain or illustrate the meaning of that word or phrase.").

The CMBS industry is premised upon non-recourse protection with a few narrow exceptions where non-recourse protection is lost. The borrower and lender make a bargain that permits financing on a non-recourse basis. The lender agrees not to pursue recourse liability directly or indirectly against the borrower or its owners in exchange for the borrower's agreement that the SPE and the financed asset will be ring-fenced from all other endeavors, creditors, and liens related to the affiliates. The ringfence ensures that

the commercial property is able to fund the loan obligations sufficiently since the SPE has only one asset – the real property that is the collateral for the commercial mortgage, such as a shopping mall or apartment building.

Protecting the asset from other liabilities is essential to maintaining the confidence of investors who provide capital for the loans. Investors in CMBS loans are primarily interested in protecting the cash flow from the property to fund their obligations since investors are typically pension funds, mutual funds, or other institutional investors. These investors need to have assurance that if the borrower defaults, the lender will have quick and easy access to the collateral. It is not an exaggeration to say that if a CMBS lender is not comfortable with the isolation of the real property asset to be financed, including the cash flows derived from the operation of such asset, then no financing will occur. In exchange for maintaining that entity separate and apart from the rest of the borrower's assets, the borrower is entitled to non-recourse protection. If the SPE fails and cannot fund its obligations, the sole remedy of the lender (and, by extension, the pooled trust that holds the loans on behalf of the bond holders) is to take the SPE property.

By holding that a borrower's insolvency constitutes failure to maintain its SPE status and triggers recourse liability for the borrower and the guarantor, the court ignored standard industry practice. Moreover, there is no industry definition of SPE that expressly requires ongoing solvency as a condition to maintain SPE status. Under industry practice, non-recourse protection generally is lost only if the SPE owner engages in prohibited conduct that inures to the detriment of the trust or lender. The SPE owner

loses its non-recourse right in these circumstances because it has failed to protect the corpus of the SPE owner and, thus, to honor the ringfence. These recourse triggers illustrate the narrow limitations on recourse found in most CMBS loans. With respect to the recourse triggers for actual losses and those for full recourse liability for the entire loan amount, the purpose is the same: to provide a credible and enforceable disincentive for the borrower to engage in any act that would compromise the ringfence, thus impairing the isolation of the financed asset and the cash flows derived from its operation. These "bad acts," or "recourse triggers," are generally divided into two categories, with differing recourse consequences.

There are a few triggers that result in full recourse liability for the outstanding loan amount, and they do not include the insolvency of the borrower. Under standard industry practice in CMBS loans, the lender may seek recourse liability against the borrower upon three narrow triggers. Under these triggers, the lender may seek the amount of the total outstanding balance of the mortgage loan, plus any accrued and unpaid interest, regardless of whether the lender actually suffered a loss:

> (1) a material breach by the borrower or its affiliates of the separateness covenants;
>
> (2) any breach of the due-on transfer or due-on encumbrance provisions of the loan documents; or
>
> (3) any voluntary or collusive involuntary bankruptcy or insolvency filing by or on behalf of the borrower.[5]

[5] It is important to note that it is not the insolvency that triggers the loss of the non-recourse protection but the seeking of protection of the bankruptcy court.

In the other category of recourse triggers, recourse is limited to the amount of any losses incurred by the lender. The lender is required to demonstrate the existence of the resource trigger, as well as the magnitude of its loss. These recourse triggers include:

> (1) fraud or intentional misrepresentation by the borrower or its affiliates;
>
> (2) the misapplication or misappropriation of rents received by the borrower if the loan were in default;
>
> (3) the misapplication or misappropriation of tenant security deposits or rents collected more than one month in advance;
>
> (4) the misapplication or the misappropriation of insurance proceeds or condemnation awards;
>
> (5) the borrower's failure to pay real estate, except to the extent that there is insufficient cash flow from the operation of the mortgaged property, or to pay charges for labor or materials or other charges that can create liens on the mortgaged property beyond any applicable notice and cure periods specified herein; or
>
> (6) any act of actual waste or arson by borrower or any affiliate.

Parties that enter into CMBS loans are sophisticated enough to negotiate for different non-recourse protections and limited recourse provisions if they so desire. They could even expressly agree that the borrower's insolvency would trigger recourse for the borrower and guarantor. Absent such agreement, however, a court should not interpret silent or ambiguous terms in the loan documents to override the non-recourse protections

that are the foundation of CMBS loans in favor of the narrow exceptions defined by limited recourse provisions.[6]

II. The Court of Appeals' Two Sources of Extrinsic Evidence Do Not Support Its Conclusion That The Non-Recourse Loan Became Fully Recourse For The Borrower And Guarantor Upon The SPE's Insolvency

Here, the loan documents were silent regarding whether the borrower must remain solvent to retain its status as an SPE. Like many other loans in the CMBS industry, the loan documents in this case "provide[d] for full recourse liability in the event that Cherryland failed to maintain its 'single purpose entity' status." Slip op. at 7. Section 9(f) in the mortgage provided that "'Mortgagor . . . will remain solvent and Mortgagor will pay its debts and liabilities (including, as applicable, shared personnel and overhead expenses) from its assets as the same shall become due.'" *Id.* at 8 (emphasis omitted). The parties disagreed whether the solvency provision in Section 9(f) was required for Cherryland " to maintain SPE status." *Id.* at 9.

The Court of Appeals recognized that the phrase "single purpose entity" was not defined in the loan documents, and it found that the phrase "is a specific, technical term in the mortgage business." *Id.* at 10 (internal quotation marks omitted). The court below acknowledged that "[t]erms in a particular trade are given their natural and ordinary meaning in the trade." *Id.* (internal quotation marks omitted). Thus, in "defin[ing] an

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[6] *See also* Joseph Philip Forte, "Topsy-Turvy: The World of Commercial Real Estate Finance Turned Upside Down," 5 Real Est. L. & Industry Rep. (BNA) No. 181 (Mar. 20, 2012) (discussing in detail the history of SPEs and the development of non-recourse financing and asset isolation).

undefined technical term," the court appropriately considered extrinsic evidence to "determine the trade definition for 'single purpose entity.'" *Id.* at 11.

The court below relied on two pieces of extrinsic evidence – Standard & Poor's ("S&P") US CMBS Legal and Structured Finance Criteria definition of a "single purpose entity" and CREFC's New York *amicus* brief. Neither source, however, supports the court's unprecedented conclusion that the borrower loses non-recourse protection if it becomes insolvent. *See* Attorney General's *Amicus* Br. at 12-15.

The S&P's US CMBS Legal and Structured Finance Criteria defines "single purpose entity" as "an entity . . . that is unlikely to become insolvent as a result of its own activities and that is adequately insulated from the consequences of any related party's insolvency." Slip op. at 11. The court assumed that "[n]othing in this definition suggests that [maintaining solvency as required] in section 9 of the mortgage [is] not required to main SPE status." *Id.* But S&P's definition supports the exact *opposite* conclusion. On its own terms, this definition expressly contemplates that an SPE could become insolvent "as a result of its own activities." *Id.* The SPE is protected from insolvency of *related* parties, such as the owner of the SPE. CREFC agrees with the Attorney General that nothing in S&P's definition of "single purpose entity" would require the SPE to remain solvent after being formed as part of non-recourse protection. *See* Attorney General's *Amicus* Br. at 12-13.[7]

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[7] Under the Dodd-Frank Act, issuers of asset-backed securities are required to do a comparison of the representations and warranties compared to standard industry set. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act § 943(1), Pub. L. No. 111-203 (2010). CREFC developed a standard set of representations and warranties to serve

The court's reliance on CREFC's New York *amicus* brief filed in a bankruptcy case, *In re Gen. Growth Props., Inc.*, 409 B.R. 43 (Bankr. S.D.N.Y. 2009), is similarly misplaced. CREFC's New York *amicus* brief contains an extensive discussion of "asset isolation and the critical role" that it serves in the CMBS market. CREFC's NY *Amicus* Br. at 2. As CREFC explained in that brief, lenders are willing to make CMBS loans only because borrowers agree to isolate the asset, which is usually accomplished through separateness covenants. Borrowers are willing to isolate the asset only because they can count on non-recourse protection in the event the SPE cannot fund the loan obligation. *Id.*

CREFC's New York *amicus* brief identified sample separateness covenants, including the borrower's agreement that it would remain solvent. CREFC's NY *Amicus* Br. at 10. The court below acknowledged that the sample separateness provisions outlined in CREFC's New York *amicus* brief "could indicate . . . that there are, in fact, no SPE covenants contained in the mortgage, only separateness covenants." Slip op. at 11. Without any support from CREFC's New York *amicus* brief, the court below then concluded that a "different interpretation is more likely – that separateness is a component part of SPE, such that maintaining SPE status requires abiding by the

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as the baseline reference point. The CREFC model representations and warranties include the following with respect to SPE status that echoes the S&P's definition of "single purpose entity." *See generally* Model Representation No. 33, CREFC – Model Representations and Warranties (Mar. 2011), available at http://www.crefc.org/uploadedFiles/CMSA_Site_Home/Government_Relations/CMBS_20/CREFC_Model_Reps.pdf.

separateness covenants," and that the loan became fully recourse because Cherryland was insolvent. *Id.*

CREFC's New York *amicus* brief in no way supports such an interpretation. In *General Growth Properties*, the owner of the SPE went bankrupt and sought to consolidate SPEs into the parent, and CREFC's New York *amicus* brief argued in support of maintaining separate SPE structures. CREFC filed the *amicus* brief in the bankruptcy proceeding because GGP made statements regarding its SPE subsidiaries "without acknowledgement of the separate and independent nature of these entities." CREFC's NY *Amicus* Br. at 17. As the Attorney General explained, CREFC's New York *amicus* brief does not address the meaning of a "single purpose entity," let alone whether separateness is related to SPE status. *See* Attorney General's *Amicus* Br. at 14-15.[8]

As discussed in Part I above, the court's interpretation not only conflicts with industry practice but also violates a cardinal principle of contract interpretation by rendering meaningless the central provision in CMBS loans – the non-recourse right, with only a narrow range of exceptions that trigger recourse. For those reasons, the lower court's vitiation of the loan's non-recourse protection should be rejected.

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[8] In fact, as the CREFC model representations and warranties make clear, the loss of the non-recourse right is very limited. *See generally* Model Representation No. 28, CREFC – Model Representations and Warranties (Mar. 2011), available at http://www.crefc.org/uploadedFiles/CMSA_Site_Home/Government_Relations/CMBS_20/CREFC_Model_Reps.pdf; *see also* Joseph Philip Forte, "Topsy-Turvy: The World of Commercial Real Estate Finance Turned Upside Down," 5 Real Est. L. & Industry Rep. (BNA) No. 181 (Mar. 20, 2012) (discussing in detail extrinsic industry standards and practices).

CONCLUSION

CREFC respectfully submits the foregoing *amicus* brief for consideration by the Court.

Respectfully submitted,

Jamie B. Beaber (P63576)
Scott A. Sinder (*Pro hac vice* application pending)
Kathryn J. Gainey (*Pro hac vice* application pending)
STEPTOE & JOHNSON LLP
1330 Connecticut Avenue, N.W.
Washington, DC 20036
Telephone: (202) 429-3000

Attorneys for *Amicus Curiae*
CRE Finance Council

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