Recourse: What’s the value of your signature?

March 2019

Should you promise to stand behind the loan on your property? Your gut reaction might be “I always pay my debts.” I’m right there with you. However, no one wants misfortune at one property to sink their whole balance sheet. As such, many investors opt for non-recourse debt to protect their net worth. Let’s review what recourse means with respect to commercial mortgages.

Recourse. A recourse loan provides the lender a repayment source in addition to the collateral securing the loan. This additional repayment source is a personal guaranty from you, the investor. So if your loan goes into default, the lender can seek repayment from your personal assets to make them whole by covering the deficiency between the outstanding loan balance and the value of the foreclosed collateral property.

Non-recourse. Non-recourse loans limit the lender’s repayment source to the collateral property with no recourse or ability to ask for repayment from the owners/principals. In other words, the investors do not guarantee repayment with the exception of carve-outs. So if your loan goes into default, you will not be personally liable for repayment of that loan unless you triggered a carve-out condition.

Carve-outs. Non-recourse loans include carve-outs to the non-recourse provision such that the principal investors can trigger a repayment guaranty, or recourse, by committing certain “bad-acts.” The exceptions that trigger liability include fraud, failure to maintain insurance, environmental issues, voluntary bankruptcy, and other “bad acts” where the loan parties act in a negligent manner that impairs the value of the collateral property. Hence, the industry often refers to these provisions as “bad-boy carve-outs.”

So which to choose? All else being equal, most investors would choose a non-recourse loan since it protects their other assets. However, the reality is not equal. Non-recourse increases the risk profile of a loan as the lender doesn’t have a repayment guaranty. As such, most lenders will limit non-recourse to higher quality collateral with more conservative structure and higher pricing. Many lenders increase the interest rate by 0.125%-0.375% for non-recourse. Some will ask for escrow/impound accounts for taxes and insurance.

Furthermore, the propensity to offer non-recourse varies across lender types. Banks prefer recourse and make up nearly half of the lending market. On the other hand, the next most common lender types are agency (Fannie Mae and Freddie Mac) and CMBS. These lenders offer non-recourse as part of their standardized products. This ensures consistency when they securitize their portfolios into bonds and sell them to investors. This requirement for consistency can further limit flexibility.

If you have a lower risk loan (no more than 50% LTV, at least 1.50x debt service coverage ratio), you may want to provide recourse to get a lower rate and save on interest expense. In addition, lenders provide more flexibility on recourse loans guaranteed by strong sponsors. However, some partnership and tax scenarios may limit your ability to provide recourse. Consider that a repayment guaranty has value worth at least as much as the interest savings. Consequently, you may be giving away value to your partners while bearing significant risk if you are the only guarantor for the loan on your mutual property.

An ethical question? Many investors have reconciled their personal ethics with their preference for non-recourse commercial financing by acknowledging the business nature of the relationship. Specifically, the bank financed the property knowing the collateral property is the only repayment source for their loan. Furthermore, the investor is in first loss position, so the bank has the advantage of getting repaid first when they foreclose and sell the collateral. Each party--lender and borrower--entered the transaction aware of the risks. Consider that a significant portion of the multifamily mortgage market is originated through agency and CMBS, which are predominantly non-recourse originations. Lastly, consider that most Californians are already taking advantage of non-recourse debt with their personal mortgage. California CCP §580 affords anti-deficiency protection to direct borrowers. It is by virtue of a separate agreement--the guarantee--that you can become personally liable for the deficiency.

If you already know you want non-recourse, start by searching for a lender that doesn't increase pricing. On the other hand, if you have no doubt in your property's ability to support your loan obligation, consider recourse debt as a way to save on interest expense and get more flexibility. If you're working with a mortgage broker, they should be able to guide you accordingly.

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