Commercial Property Owners May Be Held Personally Liable For Sour Investments

by Joel R. Glucksman on April 6, 2012

A new ruling in Michigan may give creditors more legal backing to go after the personal assets of commercial real estate landlords whose properties are foreclosed on.

Current laws protect commercial property owners from losing their personal assets to creditors when real estate investments are no longer viable. With non-recourse loans, once commercial landlords give up their properties, most creditors are legally barred from obtaining other types of assets. However, a Michigan appellate court recently upheld the decision of a lower court, which ruled that bondholders were justified in launching a personal lawsuit against strip-mall owner David Schostak after he defaulted on a loan, according to the Wall Street Journal.

The bondholders were allowed to sue Schostak personally due to the "bad boy" clause in his mortgage contract. The provision permits lenders to sue for personal assets and holdings if landlords engage in prohibited actions, such as fraud, the Journal explains. The bondholders argued that the provision was applicable for "special-purpose entities" that did not remain solvent, the newspaper adds.

Bad-boy clauses are typically incorporated in most loan contracts as a strategy for preventing borrowers from seeking protection under U.S. bankruptcy law when investments fail. However, Schostak's counsel argued that the provision was not designed to be so invasive.

As a result of the ruling, experts say that many creditors across the country may take similar actions against commercial real estate holders, with cases in New York and California already on the docket. However, the Michigan legislature has called the new practice into question in light of the court decision, and analysts say the ambiguity around the provision may spark more inquiries into how far-reaching the bad-boy clause should be.