'BAD BOY' CARVE-OUTS AND THEIR EFFECT ON NONRECOURSE DEBT

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The determination of personal liability can become difficult where a nominally 'nonrecourse' loan has become recourse, in whole or in part, due to 'bad boy' carve-out provisions.

Discharge of indebtedness clearly has tax consequences for debtors, but it also has tax consequences for lenders.[1] Of particular importance is the lender's duty to file an information return on Form 1099-A or Form 1099-C reporting the transaction to the IRS.[2] Both forms require the lender to check box 5 if the debtor was "personally liable" for repayment of the debt. The Instructions clarify that the determination of whether a debtor was personally liable for repayment of the debt is made "at the time the debt was created, or, if modified, at the time of the last modification...."[3] Usually it is not difficult for a lender to determine whether the debtor was or was not personally liable for the debt. However, this determination can become quite difficult where a nominally "nonrecourse" loan becomes recourse (in whole or in part) following application of one or more "bad boy" carve-out provisions in the loan documents. Under such circumstances, an otherwise nonrecourse loan may become recourse for federal tax purposes as a result of breaching the bad boy carve-outs.

Stakes for the debtor

Discharge of indebtedness can have drastically different tax consequences for debtors, depending on whether the discharged debt is recourse or nonrecourse and the manner in which the discharge occurs.[4] Generally, where a lender cancels or writes down recourse or nonrecourse debt for no consideration, the debtor realizes cancellation of indebtedness income (CODI) under Section 61(a)(12). CODI is ordinary income (currently taxed at a maximum ordinary income tax rate of 35%) and potentially may be excluded from income under one of the exceptions set out in Section 108(a).[5]

However, where a debtor transfers collateral securing debt to the lender in satisfaction of the debt (such as in a foreclosure, deed in lieu, or repossession), the transaction is treated as a sale or exchange on which gain or loss is recognized.[6] The debtor's amount realized in the deemed sale depends on whether the debt is recourse or nonrecourse. If the debt is nonrecourse, the debtor is deemed to have sold the collateral to the lender for the principal balance of the debt, even if the amount of the debt exceeds the collateral's fair market value.[7] If the debt is recourse, the transaction is bifurcated such that the debtor is deemed to have sold the collateral to the lender for the fair market value of the collateral, and the excess discharged amount results in ordinary CODI.[8] As a result, assuming the collateral is either (1) a capital

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asset held for more than one year or (2) "property used in the trade or business" of the debtor,[9] any gain realized on the transfer of the collateral to the lender generally will be long-term capital gain.[10] Unlike CODI, capital gain from foreclosure may not be excluded under Section 108, which applies only to ordinary income from cancellation of indebtedness.[11] However, foreclosure gain is eligible for deferral as part of a like kind exchange under Section 1031.[12]

As the foregoing discussion indicates, most debtors have a preference about whether discharged debt is recourse or nonrecourse for federal tax purposes.[13]

Example. Taxpayer is an individual real estate investor who purchased vacant land for investment in 2000 using $10 million of equity and $5 million of debt borrowed from Big Bank. Taxpayer took a $15 million initial cost basis in the land. In 2006, when the fair market value of the land was $40 million, Big Bank refinanced the debt and allowed Taxpayer to borrow $25 million using the land as collateral. By 2011, the land had fallen in value to $20 million, Taxpayer had ceased making payments on the debt, and Big Bank had foreclosed and purchased the land at a trustee's sale for the $25 million principal amount of the debt. The balance of the debt was discharged pursuant to the foreclosure. At that time, Taxpayer's adjusted basis in the land remained $15 million. If the debt is nonrecourse, Taxpayer realizes $10 million of long-term capital gain in the foreclosure ($25 million amount realized less $15 million adjusted basis), resulting in a tax liability of $1.5 million at the maximum 15% long-term capital gain rate. However, if the debt is recourse, Taxpayer's total tax liability from the foreclosure is $2.5 million, including $750,000 of long-term capital gain ($20 million amount realized less $15 million adjusted basis times 15%) and $1,750,000 of ordinary CODI ($5 million excess amount times the top ordinary income rate of 35%).

Unlike CODI, capital gain from foreclosure may not be excluded under Section 108.

If Taxpayer in this example is unable to exclude CODI (e.g., he or she is not insolvent or in bankruptcy and the debt is not "qualified real property business indebtedness"), he or she undoubtedly will prefer for the debt to be nonrecourse, because the result is $1 million less in total tax liability. If, however, Taxpayer is eligible to exclude the CODI under Section 108(a), he or she may prefer the debt to be recourse, which would make the immediate tax liability only $750,000 (i.e., the deemed tax on the sale gain).[14]

Whether the debt is recourse or nonrecourse, Taxpayer may decide to defer the foreclosure gain pursuant to a Section 1031 exchange. If Taxpayer intends to use a Section 1031 exchange to defer gain, he or she generally

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1 For purposes of this article, "lender" means either a "lender" as defined in Reg. 1.6050J-1T or an "applicable entity" as defined in Section 6050P(c)(1), as the context requires.

2 See Sections 6050J, 6050P. Generally, a lender files Form 1099-A to report the acquisition of secured property in full or partial satisfaction of the debt and Form 1099-C to report cancellation of indebtedness in excess of $600.

3 See Instructions to IRS Forms 1099-A and 1099-C.

4 The distinction between recourse and nonrecourse debt also is relevant for purposes of determining the extent of a debtor's insolvency. See Section 108(d)(1); Rev. Rul. 92-53, 1992-2 CB 48.

5 A discussion of Section 108 and the exclusions from CODI is beyond the scope of this article. For a good discussion of Section 108, see Lipton, "Real Estate Debt Workouts in 2008—The Rules Have Changed," 108 J. Tax'n 4, page 207 (April 2008).

6 See Sections 61(a)(3), 1001; Davis, 370 U.S. 65, 9 AFTR2d 1625 (1962); Helvering v. Hammel, 311 U.S. 504, 24 AFTR 1082 (1941); Aizawa, 99 TC 197 (1992).

7 See Tufts, 461 U.S. 300, 51 AFTR2d 83-1132 (1983); Russo, 68 TC 135 (1977); Freeland, 74 TC 970; Yarbro, 737 F.2d 479, 54 AFTR2d 84-5774 (CA-5, 1984); Est. of Delman, 73 TC 15 (1979); Rev. Rul. 76-111, 1976-1 CB 214 ("It is well established that, for federal income tax purposes, the transfer of assets in consideration of a cancellation of indebtedness is equivalent to a sale upon which gain or loss is recognized in the amount of the difference between the basis of the assets transferred and the amount of the indebtedness that is cancelled in consideration of the transfer."); Rev. Rul. 90-16, 1990-1 CB 12; GCM 38385, 5/23/80 ("It is well established that a foreclosure sale, in which the property securing the debt is repossessed from the mortgagor, constitutes a taxable sale or exchange."). The result is the same whether the debtor transfers the collateral involuntarily through a foreclosure sale or whether the debtor transfers the collateral voluntarily via a deed in lieu of foreclosure. See 2925 Briarpark, Ltd., 163 F.3d 313, 83 AFTR2d 99-312 (CA-5, 1999); Allan, 856 F.2d 1169, 62 AFTR2d 88-5715 (CA-8, 1988).

8 See Regs. 1.1001-2(a), 1.1001-2(c), Example 7, 1.1001-2(c), Example 8; Frazier, 111 TC 243 (1998); Rev. Rul. 90-16, 1990-1 CB 12.

9 For these purposes, "property used in the trade or business" has the meaning given in Section 1231.

10 An individual's long-term capital gain currently is taxed at a maximum rate of 15%. It should be noted that all or a portion of such gain instead may be recaptured at ordinary income rates or Section 1250 gain taxed at 25%. See Sections 1, 1245, 1250, 1254.

11 See 2925 Briarpark Ltd., *supra* note 7.

12 See Borden and Keator, "Workout-Driven Exchanges," 25 Tax Management Real Est. J. 2, page 23 (2/4/09). CODI is never eligible for a Section 1031 exchange. *Id.*

13 See Great Plains Gasification Associates, TCM 2006-276 ("the characterization of discharged debt as recourse or nonrecourse may affect the character of any gain or loss on the transaction"); Coburn, TCM 2005-283 (the distinction between recourse and nonrecourse debt "may affect the character of any gain or loss on the transaction and the availability of certain exclusions from gross income"); FSA 200135002, 4/10/01 (taxpayer arguing debt was recourse to utilize exclusions under Section 108, IRS arguing debt was nonrecourse).

14 The attribute reduction rules in Section 108(b) will have a bearing on this determination.

will prefer for the debt to be nonrecourse because the full $10 million of gain would be eligible for deferral. If the debt were recourse, by contrast, only $5 million of the gain from foreclosure would be eligible for a Section 1031 exchange (and the $5 million of CODI would not be eligible).

From a federal tax perspective, a lender foreclosing on collateral generally is indifferent as to whether the debt is recourse or nonrecourse for federal tax purposes. However, the lender must indicate on Form 1099-A or Form 1099-C whether the debtor was "personally liable" for repayment of the debt.[15] Such a determination must be made by either the date of the debt's issuance or the date of its last "modification," whichever is later. For this purpose, modifications of debt instruments under Section 1001should be taken into account.

Whether the debt is recourse or nonrecourse, a taxpayer may decide to defer foreclosure gain pursuant to a Section 1031 exchange.

Thus, for information reporting purposes, it is important that the lender be able to ascertain whether the debt at issue in a foreclosure is recourse or nonrecourse. In questionable situations, such as defaulted "nonrecourse" loans where the parties disagree about whether one or more of the recourse carve-outs have been breached, the lender may use the ambiguity as an opportunity to negotiate a more favorable settlement with the borrower. Looking at the example above, if there is uncertainty as to whether the debt has become recourse due to breach of a bad boy carve-out, and the taxpayer prefers for the debt to be nonrecourse in order to realize all long-term capital gain or to utilize a Section 1031 exchange, the lender, for additional consideration, may decide not to enforce the carve-outs, with the result that the debt should remain nonrecourse for federal tax purposes. Similar negotiations also could occur if the Taxpayer preferred for the debt to be recourse (e.g., in order to take advantage of the exclusions under Section 108).

Determining what's what

Neither the Code nor the regulations defines terms "recourse" or "nonrecourse" for purposes of determining a debtor's tax consequence when collateral is conveyed to the lender in satisfaction of a debt (whether by foreclosure or deed in lieu thereof).[16] However, examples in the regulations imply that whether debt is recourse or nonrecourse turns on the personal liability of the debtor.[17] Despite the examples, one is left to speculate as to the precise meaning of these words. In many (and probably most) situations, it is relatively easy for the parties to determine whether debt is recourse or nonrecourse. The Tax Court has cited *Black's Law Dictionary* in the past for the definitions of recourse and nonrecourse debt.[18] Under these definitions, a "recourse" debt is one "that may be satisfied upon default by pursuing the debtor's other assets in addition to the collateral securing the note."[19] A "nonrecourse" debt is one "that may be satisfied upon default only be means of the collateral securing the note, not by the debtor's other assets."[20]

In 2002, the IRS examined whether certain notes were recourse or nonrecourse for Section 1001 purposes.[21] The notes at issue in that examination were "straightforward promises to pay and [did] not contain exculpatory clauses that might prevent [the] creditor from obtaining a deficiency judgment." The IRS defined a recourse debt for purposes of Section 1001 as "one for which the debtor is personally liable, that is, the creditor may have recourse against

[15] See Reg. 1.6050J-1T, Q&A-26(d), Reg. 1.6050P-1(a)(1)(v); Instructions to IRS Forms 1099-A and 1099-C.

[16] See Frankel, "Tax Planning for Troubled Real Estate and Partnership Transactions—Part 2," 20 J. Real Est. Tax'n, No. 1 (Fall 1992) ("These regulations do not provide any guidance regarding when a partnership debt should be treated as recourse or nonrecourse."); Garlock, *Federal Income Taxation of Debt Instruments*, ¶ 1501.04. By contrast, the regulations under Section 752 define "recourse" and "nonrecourse" liabilities for purposes of allocating liabilities of a partnership among the partners. Generally, a partnership liability is recourse if a partner bears the economic risk of loss for the liability and is nonrecourse to the extent that no partner bears the economic risk of loss. See Regs. 1.752-1, 1.752-2. As discussed below, both the IRS and at least one court have looked to these definitions for support in classifying liabilities under Section 1001.

[17] See Reg. 1.1001-2(c), Example 7 (implying that "nonrecourse debt" is debt for which the debtor is "not personally liable" and the creditor's only recourse in the event of default is to specified collateral); Reg. 1.1001-2(c), Example 8 (implying that "recourse debt" is debt for which the debtor is "personally liable" to the creditor).

[18] See Coburn, *supra* note 13.

[19] *Black's Law Dictionary*, 1086 (West, 1999).

[20] *Id.* See also Racine, 493 F.3d 777, 100 AFTR2d 2007-5087 (CA-7, 2007) (defining a nonrecourse loan for purposes of Section 83 as an arrangement in which "the lender agrees to look *exclusively* to the collateral, and never to dun the borrower for a deficiency if a sale of the collateral fetches less than the balance"). Emphasis in original.

[21] See Non-Docketed Significant Advice Review (NSAR) 20020142, Vaughn # 20142 (2/26/02).

[22] See Regs. 1.752-1(a)(1), (2).

the debtor if the security is not sufficient to pay the debt." Further, according to the IRS, "[t]he task of classifying an obligation as recourse or nonrecourse for Federal tax purposes generally requires an examination of all the facts and circumstances with the legal rights and obligations of the parties determined under applicable state law."

The IRS then looked to the rules under Section 752 for support. For purposes of Section 752, a partnership liability is recourse "to the extent that any partner or related person bears the economic risk of loss" and a liability is nonrecourse "to the extent that no partner or related person bears economic risk of loss for that liability."[22] To determine whether a partner bears the economic risk of loss for a liability, the regulations employ a constructive liquidation test under which all of the partnership's liabilities become due and payable and all of its assets are deemed sold in a taxable transaction for no consideration. The partners that would be required to reach into their pockets to pay off the debt of the partnership in this scenario are considered to bear the economic risk of loss for such debts.

The IRS applied the Section 752 analysis to determine that the debtor would be liable for the debt without recourse to the other obligors for indemnification or contribution. Further, the IRS found that there was no agreement between the parties that prevented the lender from pursuing a deficiency judgment should the collateral prove inadequate. Therefore, the IRS ruled that the debt was recourse.

This ruling reveals three key principles for evaluating whether debt is recourse or nonrecourse under Section 1001:

1. State law determines the legal rights and obligations of the parties that must be analyzed under federal income tax principles.
2. The ability of the lender to pursue a deficiency judgment against the debtor is evidence that the debt is recourse.
3. The economic risk analysis under Section 752 and the regulations thereunder is relevant to the determination.

The IRS addressed a similar issue in FSA 200135002. There, P formed S as a wholly owned corporate subsidiary for the limited purpose of constructing hydroelectric plants. B provided a loan to S for this purpose pursuant to a "Limited Recourse Project Funding Agreement." The collateral for the loan consisted of S's interest in the land and hydroelectric plants. In addition, P guaranteed the loan and pledged its stock in S as additional security. The facts of the ruling state that S's collateral consisted of almost everything S owned at the time it entered into the loan agreement and that none of the loan documents stated that S would be liable for the loan if the collateral and other security interests proved insufficient.

The hydroelectric plants declined in value, S defaulted on the loan to B, and B agreed to allow S to sell the collateral and remit the full proceeds (which were less than the principal balance of the debt) to B in satisfaction of the debt. At issue was whether the loan was re-



course, in which case a portion of the discharged debt would be CODI eligible for exclusion under Section 108 (S was insolvent), or nonrecourse, in which case the entire discharged debt would give rise to capital gain that could not be excluded. For obvious reasons, S argued that the loan was recourse.

The IRS disagreed with the taxpayer and determined that the loan to S was nonrecourse. The IRS reasoned that the "Limited Recourse Project Loan Agreement" limited the recourse of B (the lender) to the assets that were specifically encumbered by the deed of trust and other loan documents. The IRS also looked to state law (California in this case) to determine that a "limited recourse loan" was equivalent to a "nonrecourse loan" within the meaning of Reg. 1.1001-2. Thus, the IRS concluded that "the rights of a creditor with respect to a limited recourse loan are not as great as the rights of a creditor with respect to a recourse loan. In this case, we conclude that B could not have, for example, attached assets of S that were not specifically mentioned in the Loan Agreement." Accordingly, the IRS found the loan to be nonrecourse for purposes of Section 1001.

For information reporting purposes, it is important that the lender be able to ascertain whether the debt at issue in a foreclosure is recourse or nonrecourse.

The key principles in FSA 200135002 relied on by the IRS were that (1) the creditor's rights were limited to the specific items of collateral referenced in the loan documents and (2) the creditor could not pursue a deficiency against S. The IRS looked to state law in determining these rights.

More recently, in *Great Plains Gasification Associates, et al.*,[23] the Tax Court addressed whether a loan to a North Dakota general partnership was recourse or nonrecourse for purposes of determining the tax consequences from a foreclosure sale. Briefly stated, the partnership was formed by five energy companies for the purpose of building and operating a coal gasification plant. The partnership agreement limited the partnership's business purpose solely to the construction, ownership, and operation of the plant. To fund the project, the partnership borrowed $1.5 billion from the Federal Financing Bank. The loan documents provided that "any recovery on a claim against Borrower [the partnership] or any Partner which may arise under this Agreement ... shall be limited to the assets of the Borrower and such Partner's interests in such assets." The project proved unprofitable, and ultimately the lender instituted foreclosure proceedings that concluded in 1987. One of the key issues addressed was whether the loan was recourse or nonrecourse for purposes of Section 1001. The answer affected both the timing and character of the partnership's income from discharge of the debt.

The court found that "[i]ndebtedness is generally characterized as 'nonrecourse' if the creditor's remedies are limited to particular collateral for the debt and as 'recourse' if the creditor's remedies extend to all the debtor's assets."[24] The court also looked to the definitions used in the regulations under Section 752 for support, finding that a nonrecourse liability was one with respect to which none of the partners bore personal liability. Ultimately, the court held that the liability was nonrecourse because the lender's remedy for default was limited to the partnership's assets and the partners (who were general partners) did not have any personal liability. According to the court:

> Pursuant to the terms of the loan guarantee agreement, [lender's] recovery on any claim was limited to the partnership's assets and to the partners' interests in those assets. Pursuant to the indenture of mortgage for the loan guarantee agreement, the collateral for the debt included all project assets, including all real or personal property "now owned or hereafter acquired by" the partnership. Insofar as the record reveals, the partnership had no significant assets apart from the project assets that were foreclosed upon. Indeed, pursuant to the partnership agreement and loan guarantee agreement, the partnership was not authorized to acquire nonproject assets or to engage in any business other than the project.... In these circumstances, the partnership's liability on the debt was effectively limited to the project assets that collateralized the indebtedness, and the partners' liabilities were effectively limited to their interests in those project assets. In these circumstances, the debt was in substance nonrecourse against the partnership and the partners.[25]

Consequently, the court held that the partnership had to take into account the full $1.5 billion balance of the debt as its amount realized on the disposition of the project assets in foreclosure. It is not clear how much emphasis the court placed on its analysis of the debt under Section 752.

The preceding discussion has dealt with loans that are either entirely recourse or entirely nonrecourse. However, there are debt instruments under which the borrower bears recourse liability for a portion of the loan, and the balance is nonrecourse. There is little authority addressing whether these "partially recourse" instruments should be classified as recourse or nonrecourse for purposes of Section 1001.

In Ltr. Rul. 8348001, the IRS addressed the situation of a taxpayer who purchased an unimproved tract of real property by issuing a purchase money note to a lender. The taxpayer

was personally liable for a portion of the principal amount and for all interest on the note. The remaining amount of principal was nonrecourse. Eventually, the lender foreclosed on the collateral. As part of the foreclosure, the taxpayer made an additional cash payment to the lender and the lender agreed never to assert or prosecute any action against the taxpayer for a deficiency. This agreement served to release the taxpayer from further liability on the note.

The issue was whether the settlement and foreclosure caused the taxpayer to recognize income. The IRS found that the settlement and foreclosure constituted a sale or exchange of the collateral to the lender. Further, the IRS found that the settlement payment was first allocated to the nonrecourse portion of the debt:

When a debt is partially recourse and partially nonrecourse, it is reasonable to assume that a settlement of the debt, whether by the payment of a lump sum in cash or by a transfer of property, will first be allocated to the nonrecourse portion of the debt. Only if the amount of cash, or the value of property, exceeds the nonrecourse portion of the debt should any of the settlement be considered as discharging the recourse portion. While there are no court decisions dealing with this question, a debtor should not be able to impair his or her creditor's rights by asserting that a settlement must first be applied against the recourse portion of a debt.[26] The following example illustrates the conclusion in Ltr. Rul. 8348001.

Example. Debtor purchases Property in 2000 for $1 million using 100% debt financing from Bank. Of that, $300,000 of the principal and all interest on the debt is recourse, and the $700,000 balance of the principal is nonrecourse. At a time when the fair market value of the Property is $500,000 and Debtor's adjusted tax basis in the Property is $100,000, Bank threatens to foreclose. Debtor and Bank reach an agreement whereby Debtor agrees to convey the Property and $100,000 to Bank in satisfaction of the debt, and Bank agrees not to pursue a deficiency against Debtor and to release Debtor from further liability.

Under Ltr. Rul. 8348001, Debtor's amount realized from the foreclosure would be $600,000 (the $700,000 nonrecourse portion of the debt reduced by the $100,000 cash payment), resulting in realized gain of $500,000. The $300,000 recourse balance of the debt would be discharged resulting in ordinary CODI. However, if the fair market value of the Property were $700,000 (instead of $500,000), the Debtor's amount realized from the foreclosure should be $700,000 (the value of the Property), resulting in realized gain of $600,000. The $200,000 recourse balance of the debt would be discharged resulting in ordinary CODI.

Tax consequences of breaching bad boy provisions

Having discussed the question of whether debt is recourse or nonrecourse, it is instructive to examine scenarios in which debtors engage in activities that trigger "bad boy" carve-out provisions existing in otherwise nonrecourse debt, along with the accompanying tax consequences of those activities. So far, neither the courts nor the IRS have considered a situation in which application of bad boy carve-outs has transformed an otherwise nonrecourse debt into one that is recourse.[27]

"Bad boy" or "recourse" carve-outs are prevalent in securitized debt that has risen in popularity over the past decade. These loans almost always commence as nonrecourse obligations. However, the loan documents provide that notwithstanding the nonrecourse status of the debt, personal liability will be imposed on the borrower for the commission of certain bad acts (thus, the name "bad boy" carve-outs). Generally, the carve-outs come in two varieties—actual loss provisions and full liability provisions. Under an actual loss provision, the liability of a borrower for committing a specified bad act is limited to reimbursing the lender for the actual loss sustained from the borrower's actions. Examples include the borrower's failure to pay taxes, misapplication of insurance proceeds or condemnation proceeds, and misapplication of rents. Under the full liability provisions, the borrower will become fully liable for the entire indebtedness if the borrower commits certain acts. Examples include filing for bankruptcy protection, transferring collateral without lender approval, and

The economic risk analysis under Section 752 and the regulations thereunder is relevant to the determination.

[23] TCM 2006-276.

[24] Great Plains Gasification Associates, et al., TCM 2006-276 at 1782.

[25] *Id.* It should also be noted that the partnership reported the debt as nonrecourse on its tax returns.

[26] Ltr. Rul. 8348001.

[27] Cf. TAM 9734001 The ruling noted that certain loans were nonrecourse "except for fraud or negligence." This statement implies that the loans could have become recourse had the fraud or negligence conditions been satisfied. The ruling does not address these issues.

failure to comply with special purpose entity requirements in the loan documents.

The downturn in real estate has put more emphasis on the enforceability of bad boy carve-outs (of both the limited and full recourse varieties). As illustrated below, courts examining these provisions generally have sided with lenders and enforced the debtor's personal liability. As a general proposition, courts construe bad boy carve-outs quite literally.

'Bad boy' or 'recourse' carve-outs are prevalent in 'securitized' debt that has risen in popularity over the past decade.

Example. A debtor buys a parcel of commercial real estate, which it finances through a $13.3 million loan secured by a mortgage on the property. The loan is nonrecourse but includes a carve-out clause under which the debt will convert to full recourse if the debtor financially encumbers the property without the lender's prior written consent. Thereafter, the debtor secures a subordinate loan for $400,000 without the lender's consent, which it pays off without issue. The debtor subsequently defaults on the original $13.3 million loan, after which the lender institutes foreclosure proceedings and sells the property. Because the debtor has breached an explicit term of the loan by financially encumbering the property without the lender's consent, the loan converts to full recourse at the time of the breach. Therefore, the lender can pursue the deficiency balance from the debtor and its principals.[28] This is true even though the unauthorized subordinate loan that triggered the carve-out had already been fully satisfied.

Example. The debtor is a limited partnership formed to purchase and develop residential real estate. To finance its activities, the partnership takes out a loan for $1.8 million secured by the development properties. The loan is nonrecourse, but includes a carve-out provision stating that if the debtor distributes funds in a manner contrary to that specified in the loan agreement, the debt will convert to recourse. In the course of its development activities, the debtor, in a violation of the lending agreement, pays funds in excess of $800,000 to affiliate entities for capitalized overhead expenditures. The debtor later defaults on the loan and the lender forecloses and sells the properties. Because the debtor misappropriated the funds by distributing them to its related parties in violation of the loan agreement, the debt converts to recourse, and the lender can pursue the deficiency from the debtor.[29]

Example. The debtor enters into a nonrecourse loan to finance an acquisition of real property. By its terms, the loan will convert to recourse if bankruptcy proceedings are commenced by or against the debtor that are not dismissed or otherwise resolved within 90 days of their filing, so as to permit the lender to exercise its security interest in the property. After the debtor defaults on the loan and the lender commences foreclosure proceedings, the debtor files a voluntary bankruptcy petition that is not dismissed for more than 90 days. While the debtor may argue that the loan's bankruptcy clause conflicts with and is preempted by the U.S. Bankruptcy Code, it is likely that once the bankruptcy petition is dismissed, state law will dictate whether the bankruptcy clause is enforceable, and thus whether the lender can attempt to

[28] See CSFB 2001-CP-4 Princeton Park Corp. Center, LLC v. SB Rental I, LLC, 980 A.2d 1 (NJ Super. Ct. App. Div., 2009). See also Heller Fin. Inc. v. Lee, 2002 WL 1888591 (DC Ill., 2002) (otherwise nonrecourse loan became full recourse where borrower permitted six liens totaling $820,000 to be placed upon the property without the lender's consent; following default and foreclosure, borrower held personally liable for $5 million deficiency).

[29] See Heller Fin., Inc. v. Whitemark at Fox Glen, Ltd., 2004 U.S. Dist. Lexis 18974 (DC Ill., 2004). See also Nippon Credit Bank, Ltd. v. 1333 North California Boulevard, 86 Cal. App. 4th 486, 103 Cal. Rptr. 2d 421 (Cal. Ct. App., 2001); (upholding recourse carve-outs where borrower distributed $600,000 to an affiliate and failed to pay a property tax bill of over $300,000 as a result); Bluehills Office Park, LLC v. J.P. Morgan Chase Bank, as Trustee, et al., 477 F. Supp. 2d 366 (DC Mass. 2007) (borrower deposited $2 million settlement proceeds resulting from a zoning appeal in a separate bank account beyond the lender's reach, which triggered full recourse liability under the bad boy carve-outs).

[30] See First Nationwide Bank v. Brookhaven Realty Assocs., 223 A.D.2d 618 (N.Y. App. Div. 1996). See also Federal Deposit Insurance Corporation v. Prince George Corp., 58 F.3d 1041 (CA-4, 1995) (borrower became personally liable for a foreclosure deficiency where borrower, in order to delay foreclosure proceedings through application of the automatic stay, filed for bankruptcy protection in violation of the carve-out provisions in the loan documents).

[31] Reg. 1.1001-3(e)(5)(ii)(A). See also Reg. 1.1001-3(e)(1) ("Except as otherwise provided in paragraphs (e)(2) through (e)(6) of this section, a modification is a significant modification only if, based on all facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant.").

[32] Reg. 1.1001-3(c)(2)(i).

[33] When a "significant modification" occurs, the debtor is treated as having exchanged the original debt instrument for the modified instrument. Reg. 1.1001-3(b). At the same time, the debtor should treat the previously nonrecourse debt as having been exchanged for recourse debt, and determine whether it has realized any CODI. See Section 108(e)(10).

[34] See Sands, TCM 1997-146 (finding debt to be nonrecourse where the creditor made no attempt to recover the obligation from the borrower or its general partners); R. O'Dell & Sons Co., Inc., 8 TC 1165 (1947), *aff'd* 169 F.2d 247, (CA-3, 1948) ("Since the present foreclosure was not followed up by any attempt to collect a deficiency, the proceeding to foreclose petitioner's property and the subsequent running of the short New Jersey statute have the effect under state law of transferring the property and giving petitioner an effective—if technical—defense against a deficiency judgment").

[35] Cf. Reg. 1.752-1(i) (bifurcating a partnership liability into separate recourse and nonrecourse debts where one or more partners bears the economic risk of loss as to part, but not all, of the partnership liability).

collect the deficiency balance from the debtor and its partners.[30]

While each of the above examples discusses the contractual rights and obligations of the lender and debtor when a breach of the bad boy carve-out provisions occurs, there is limited authority as to the tax consequences of the conversion of the debt from nonrecourse to recourse (either in whole or in part). The regulations under Section 1001 state that "a change in the nature of the debt instrument from nonrecourse (or substantially all nonrecourse) to recourse (or substantially all recourse) is a significant modification."[31] Notably, the regulations further provide that any "change (in whole or in part) in the recourse nature of the instrument (from recourse to nonrecourse or from nonrecourse to recourse) is a modification."[32] This is so even if the modification occurs by operation of the terms of the debt instrument.

Conclusion

Several points may be drawn from the foregoing examples and cases. The regulations are clear that if an otherwise nonrecourse debt instrument becomes recourse in whole or in part (including by application of bad boy carve-outs), the debt instrument is modified at such time, and in many cases the modification will be a "significant modification" as defined.[33] In cases such as the examples discussed above, the debt should be treated as converting from nonrecourse to recourse (in whole or in part) at the time that the debtor breaches the bad boy carve-out provision. As discussed above, such modification may drastically alter the borrower's tax consequences from the foreclosure and related discharge. The debtor may care greatly about this distinction.

When a debtor breaches a full liability carve-out and subsequently defaults, and the lender forecloses and determines that it must discharge a deficiency balance with respect to the indebtedness, the lender reasonably may determine that the borrower was personally liable for the debt at the time the debt was last modified. As a result, the lender must check box 5 on Form 1099-A or Form 1099-C to indicate that the debtor was "personally liable." Of course, lenders will have some discretion in determining whether the borrower in fact breached the bad boy carve-outs, which will determine whether a modification occurred in the first instance, which in turn will determine whether the lender must check the "personal liability" box.[34] Savvy lenders will employ such discretion as an additional tool to obtain better settlements with borrowers.

On the other hand, if the debtor has breached an actual loss carve-out, he or she will become personally liable for part, though not all, of the debt. In this situation, Ltr. Rul. 8348001 instructs that any property and cash received by the debtor must be applied first to the nonrecourse portion of the debt. Any excess amounts then reduce the recourse balance of the debt. In most cases, the practical result of this rule will be that the full amount of the lender's actual loss becomes a recourse obligation of the debtor, for which the debtor will realize ordinary CODI.

There is limited authority as to the tax consequences of the conversion of the debt from nonrecourse to recourse.

There is no direct guidance as to a lender's reporting requirements where (1) debt has undergone a significant modification as a result of becoming partially recourse and (2) the lender discharges such debt. One method for reporting the discharge would be to bifurcate the debt and issue a Form 1099-A or Form 1099-C for both the recourse and nonrecourse portions of the debt.[35] Under this method, it would be necessary to determine the relative amounts of nonrecourse and recourse debts being discharged (under the method described in Ltr. Rul 8348001), and issue a separate Form 1099 statement for each amount. Under the ordering rule imposed by the IRS, if the fair market value of the collateral and any cash payments totals less than the outstanding balance of the nonrecourse portion of the debt, the Form 1099 related to the recourse portion of the debt should show "$0" as the fair market value of the collateral. As a result, the full amount of the recourse portion of the debt would be taxable as CODI. Alternatively, because a portion of the debt has become recourse, and because the IRS has not yet published guidance to the contrary, lenders may simply be required to check box 5 indicating that the borrower was personally liable (albeit for only a portion of the debt), with no indication as to the extent of the debtor's personal liability. Further guidance from the IRS is needed to clarify this issue.■