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Carveouts and Cash Flow: Additional Impacts of Cherryland Mall

This is the third installment of [The Carveout](#), a Frost Brown Todd blog geared toward sophisticated capital market participants, with particular emphasis on what are often the most critical terms of typical commercial real estate finance (CREF) lending—non-recourse carveouts. For background, read [part one on common carveout structures in CREF](#) and [part two on the limits of non-recourse loans and lasting impact of Cherryland Mall](#).

As discussed in our preceding post, the Michigan Court of Appeals' decision in [Wells Fargo Bank v. Cherryland Mall](#) has had significant implications for non-recourse loans, particularly concerning solvency covenants often found in [special purpose entity provisions](#) that could inadvertently trigger "backdoor recourse" if not appropriately limited. Here, we will discuss the additional impacts of *Cherryland Mall* on certain common non-recourse carveouts, emphasizing the need for careful qualification to prevent unintended recourse liability.

Carveouts Related to Cash Flow That Can Be Qualified

The court in *Cherryland Mall* did not analyze the borrower's and lender's intent, but instead stayed solely within the four corners of the loan documents in deciding to impose recourse liability on the borrower's principals. In the years since *Cherryland Mall*, fear of a similar result has caused many borrowers to negotiate certain carveouts that could inadvertently create recourse liability for a failure to remain solvent. Several such common carveouts are discussed below.

- **Failure to pay charges for labor or materials:** One carveout that can lead to recourse liability is if borrower fails to pay expenses for work performed at the property or materials used. This failure can cause a mechanics' lien to attach to the

property, which would affect the mortgaged property and risk the priority of the lender's lien. Borrowers often request that this carveout be qualified to only apply to the extent that sufficient cash flow to pay such charges is available from the operation of the property. Incurring charges for labor and materials is an unavoidable part of maintaining a property, and failing to pay for those charges solely because the property fails to produce sufficient income does not necessarily imply any bad acts by the borrower or its principals. This change is therefore often agreed to by lenders, although there may be deal-specific considerations that would override the general willingness to accept this change, as discussed further below. As an example, the existence of a completion guaranty may indicate that this provision should not be limited to the extent of available cash flow. It should also be noted that most lenders will still impose liability for failing to pay charges for labor or materials incurred after the occurrence of an event of default under the loan.

- **Failure to pay taxes:** Similar to unpaid labor and material charges, unpaid taxes can create a tax lien against the collateral, which generally has priority over a lender's mortgage lien. Most non-recourse loan documents will therefore include a carveout triggered by a failure to pay taxes. By narrowing this carveout to available cash flow, lenders can ensure that the borrower is using revenues from the property appropriately to pay taxes, and borrowers can avoid inadvertently triggering recourse liability if the property is not producing adequate revenue to pay taxes. Otherwise, borrowers and guarantors may be required to pay these expenses from their own funds to avoid recourse liability, which may not reflect the parties' intent.
- **Failure to pay insurance premiums:** An important requirement in all real estate loans is the borrower's obligation to maintain insurance coverage (e.g., fire and casualty, general liability, rental interruption, flood, earthquake). If a borrower fails to pay insurance premiums, the policies could lapse and the property would be vulnerable. A standard non-recourse carveout is therefore triggered by a failure of the borrower to

pay insurance premiums, but again, lenders are often willing to qualify this carveout to only apply to the extent there is sufficient cash flow from the property to avoid triggering unintentional recourse.

- **Causing waste to the property:** Carveouts related to waste are very common, but the concept's meaning is often debated. Some interpretations hold that it is limited to the physical condition of the property (e.g., a failure to maintain the physical features of the property through action or omission), while others extend the concept to the more amorphous realm of economic waste (e.g., a [failure to maintain a parking agreement](#), franchise agreement or any other arrangement that contributes to a property's value). To remove any ambiguity, borrowers will often request that these carveouts be limited to *physical* waste, and, for the same reasons discussed above, will ask to limit them to the extent of available cash flow from the property. Otherwise, borrowers and guarantors may find themselves coming out of pocket for repairs and maintenance or facing recourse liability.

Key Issues in Negotiating Non-Recourse Carveouts

Although the changes discussed above are often accepted, some lenders may expect borrowers to pay out of pocket for taxes and insurance premiums regardless of cash flow, particularly given the severe consequences of not paying these obligations, such as a lien being placed on the property or an uninsured casualty occurring at the property. There may be additional deal-specific reasons as to why some carveouts cannot be qualified to the extent of cash flow, depending on the property type, economic history, tenant concentrations, stabilization status, lease complexities or lender's underwriting requirements. These risks underscore the importance of discussing each carveout to clarify the parties' intent, which is always the overriding negotiation principle. It should also be noted that the existence of carry guaranties or similar arrangements, which are common on non-stabilized properties, may indicate that limiting these items to the extent of cash flow generated by the

property is not appropriate.

This is not a comprehensive list of all non-recourse carveouts that can be limited to the extent of available cash flow. All deals and loan documents are unique, but this post touches on common examples of how the *Cherryland Mall* decision and the court's strict interpretation continue to affect how non-recourse provisions are viewed and negotiated.

In conclusion, qualifying non-recourse carveouts can align the goals of borrowers and lenders, preventing ambiguity and avoiding a repeat of the *Cherryland Mall* outcome. By ensuring that non-recourse carveouts are clearly defined and limited to available cash flow, borrowers can protect themselves from unintended recourse liability and maintain the non-recourse nature of their loans.

If you have questions as it relates to the topics addressed above, please reach out to the authors or any attorney with Frost Brown Todd's [Commercial Real Estate Finance Team](#). And stay tuned to [The Carveout](#) for future posts designed to help you better understand both the benefits and liabilities of carveout provisions in CREF deals, including [special purpose entity \(SPE\) provisions](#) and commonly negotiated changes.

The Carveout

A legal blog geared toward sophisticated capital market participants, The Carveout provides insight into current trends and developments in commercial real estate finance (CREF)—with a particular focus on non-recourse carveouts and CREF loan platforms including CMBS, debt funds, private capital, REITs, life insurance companies, and other complex sources of capital.

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