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Special Purpose Entity Carveouts and Recourse Liability: Practical Approaches for Lenders and Borrowers

Welcome to [The Carveout](#), where we explore some of the most negotiated and critical items in commercial real estate finance (CREF) lending, including [non-recourse carveouts](#). In today's post, we discuss non-recourse carveouts related to breaches of special purpose entity (SPE) provisions, with an emphasis on lender and borrower concerns surrounding these carveouts and common negotiated changes, particularly how ["transfers" are defined](#).

SPE Representations and Covenants

As [previously discussed](#) on *The Carveout*, non-recourse lenders require their borrowers to be special purpose entities (SPEs) that exist solely to own and operate the asset serving as collateral for the loan. That requirement ensures the borrower and the collateral—the only source of repayment available to the lender upon a borrower default, absent a non-recourse carveout—remains insulated from any other business or activities of the sponsor or other borrower affiliates and mitigates the risk posed by a bankruptcy of those affiliates.

A lengthy list of SPE-related representations, warranties and covenants are included in non-recourse loan documents, and a similar list is typically also required to be included in the borrower's organizational documents. Among other things, SPE provisions prohibit the borrower from owning anything other than the collateral, engaging in activities not related to the ownership and operation of the collateral, and incurring any additional indebtedness (other than ordinary course unsecured trade payables typically capped at 2–4% of the loan amount (depending on property type, loan amount and a variety of other factors) and, in some cases, equipment leases).

SPE provisions also require the borrower to maintain bank accounts and financial records separate from those of any affiliate, file its own tax returns, maintain separate stationery, observe organizational formalities necessary to preserve its existence and, in some instances, maintain an independent member/director whose affirmative vote is required to file for bankruptcy and take certain other material actions.

The Lender's Perspective

Requiring borrowers to be SPEs is a key feature of non-recourse lending. A borrower's failure to observe SPE requirements puts its assets (i.e., the loan collateral) at risk of being pulled into a bankruptcy of an affiliated entity and made available to satisfy the debts and obligations of that affiliated entity—a process known as “substantive consolidation.” This would be a very bad scenario for a non-recourse lender that can only look to the loan collateral to make itself whole.

For this reason, a breach of SPE provisions is often a “full recourse” carveout, permitting the lender to pursue a judgment against the borrower and the loan guarantor for the full amount of the debt. These carveouts are often simply phrased as “any breach by Borrower of Section ___ [the applicable loan document section containing the SPE provisions].” To a lender, all SPE requirements are meaningful. The failure to comply with them puts the collateral at risk, and lenders should not be required to prove how a breach resulted in a loss in order to obtain a judgment against a borrower and guarantor.

The Borrower's Perspective

From the borrower's perspective, the list of SPE provisions can look like a minefield. A typical SPE section in a non-recourse loan agreement might have 30 or more clauses containing detailed reps, warranties, and covenants. While some are obviously critical (e.g., the prohibition against incurring additional debt), the idea that inadvertently sending a communication on an affiliate's stationery would trigger full-recourse liability may seem overly punitive to a

borrower. As discussed in our prior post, ["Cherryland Mall and the Limits of Non-Recourse Carveouts,"](#) it was the breach of an SPE covenant that resulted in a full-recourse judgment against the guarantors in the now infamous *Cherryland Mall* decision. As such, the risk is not merely academic but has real-world implications. For this reason, borrowers will often want to move a carveout triggered by a breach of the SPE provisions out of the realm of full recourse and "above the line" so that the breach only results in recourse to the extent of any loss actually suffered by the lender.

A Possible Compromise

So, where does that leave things? The SPE provisions, and the protections they provide for the lender's collateral, are an important component of the non-recourse bargain the lender is making. The borrower, by comparison, does not want to trigger full recourse for the debt by committing a minor breach of the extensive SPE requirements. Though outcomes may differ based on the lender, borrower, and deal specifics, a compromise might see the SPE carveout "bifurcated" as follows: the parties will agree to move the broad carveout for *any* breach of the SPE representations, warranties, and covenants to the losses section, but will agree to retain a full-recourse carveout for a breach of an SPE provision that is cited as a factor by a court that renders a decision consolidating the assets and liabilities of the borrower with those of another party (i.e., a substantive consolidation).

In other words, if the borrower breaches one of the many SPE provisions, but there is no demonstrable loss to the lender and no substantive consolidation, that breach will not trigger recourse (though it should be noted that it may still trigger an event of default). However, if the breach of an SPE provision does result in a loss to the lender, or if a court mentions the breach as a reason for permitting the borrower's assets to be made available to satisfy the debts of an affiliate, there will be recourse to the borrower and guarantor.

Lender/Borrower Takeaways

The above-described resolution may not satisfy every lender and borrower in every situation. The borrower may want the SPE provisions themselves to be pared back or may ask that the full-recourse carveout be further narrowed (e.g., to only be triggered if a court cites an SPE breach as the “primary” or “deciding” factor in a substantive consolidation). The lender may feel that their SPE provisions are already limited as much as possible and insist upon any breach remaining in the realm of full recourse. However, bifurcating the SPE carveout is a good example of a practical solution that can, in certain instances, accommodate the concerns of both parties and put them one step closer to a successful closing.

If you have questions as it relates to the topics addressed above, please contact the author or any attorney with Frost Brown Todd’s [Commercial Real Estate Finance Team](#). You can also check out our prior posts on [common carveout structures in CREF](#), the [limits of non-recourse loans](#) after *Cherryland Mall*, and key issues in [negotiating non-recourse carveouts](#).

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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