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COMMERCIAL REAL ESTATE LAW

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Commerical real estate litigation against guarantors and debtors in today's economic climate

In the recent era of difficulty in some sectors of the commercial real estate market, lending institutions and borrowers are faced with difficult litigation decisions with respect to foreclosure and deficiency actions. With defaulting commercial real estate loans secured by property which cannot be sold or can be sold only at substantial discounts, lenders are more often today determining that they would rather pursue actions against obligors and guarantors first, without aggressively pursuing foreclosure. Lenders also have varied internal accounting rationales for not wanting to foreclose on a commercial property. These litigation decisions are made more complicated by the unsettled case law in New Jersey with respect to the application of a non-statutory fair market value credit in a deficiency action on a note or guaranty where there is a related mortgage on commercial property. When a financial institution is considering a deficiency action or litigation on a note or guaranty that is also secured by commercial real estate, the timing of such an action and evidence of value may be crucial to the debtor's right to require a fair market value credit under the current conflicting New Jersey case law.

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In the typical residential mortgage and note scenario, New Jersey's deficiency action statutes, N.J.S.A. 2A:50-2 et. seq., apply. These statutes require a lender to first foreclose on the mortgaged property before the lender can bring an action in the Law Division to recover a money judgment on a note, guaranty or other similar instrument. These are often referred to as the "foreclosure first" rules. If the deficiency action statutes do not apply, then the lender can bring an action to recover a money judgment in the Law Division at any time without filing of a foreclosure action. The foreclosure first rules do not apply where (a) the debt is for a business or commercial purpose, except a two to four family residence where the owner or his immediate family lives, (b) residential property which is not a one to four family residence where the owner or his immediate family lives, (c) the mortgage is not the primary security for the debt, or (d) the mortgage is a second mortgage where the first mortgage is held by another lender.

In the residential context where the deficiency action statutes apply, as part of the mortgage foreclosure action, the statutes require that any guarantor or obligor under the note be made part of the foreclosure action. Further, in the complaint filed, the plaintiff-lender must offer to give a fair market value credit as of the date of the foreclosure sale in any case where the plaintiff lender was the purchaser at the foreclosure sale. Interestingly, the origins of what became the statutory fair market value credit began during the Depression in the 1930's where, not wholly unlike our current real estate climate, collapsed economic conditions had destroyed the market for real estate and made it impossible to secure anything beyond a nominal bid at judicial sale. The statutes also mandate that as part of the foreclosure, the defendant has the right to contest the amount of the fair market value, and in most cases will be afforded a fair market value hearing.

The thorny issue with respect to the application of a fair market value credit rears its ugly head in cases where the deficiency action statutes do not apply – otherwise known as a "non-statutory fair market value credit." It is in this context that the case law in New Jersey does not provide clear guidance as to the debtor's entitlement to a non-statutory fair market value credit, and timing of the related actions may become significant.

Until the 1990s, the leading case on the issue of the application of the fair market credit related to a commercial loan was 79-83 13th Avenue Ltd. v. DeMarco, 44 N.J. 525 (1965). There, the Court found that in the commercial context, the right to a fair value deduction can be pursued only in the foreclosure action itself by way of an objection to the sale. Part of the basis for this decision was the Supreme Court's recognition in the mid-1960's that "general economic conditions are the reverse of those in the 30's. Times are booming, mortgage loan funds for refinancing are plentiful and lenders are competing for investments. There is an active market

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for most for most kinds of real estate and judicial sales attract prospective purchasers who bid competitively for many properties." Thus, the Court held that the defendant borrower was not entitled to a non-statutory fair market value credit in a deficiency action. Of course, the application of this analysis could leave a commercial debtor in a particularly difficult position where the bank chooses to pursue the personal deficiency action either prior to the foreclosure or contemporaneously with the foreclosure.

Next, we fast forward to 1991, when economic conditions in commercial real estate were once again looking bleak. In Citibank, N.A. v. Errico, 251 N.J. Super. 236 (App. Div. 1991), the Appellate Division addressed the application of a non-statutory fair market value credit and found that the borrower was not precluded by the entire controversy doctrine from claiming a fair market value credit where it failed to object to the sale price in the foreclosure action. There, the lender had its own expert complete an appraisal prior to the foreclosure, who concluded the fair market value to be $9,500,000. After foreclosure, due to the bankruptcy filing of another of the principal obligors, the property was purchased at a bankruptcy auction by the lender for $5,900,000, and the borrower did not object to the auction price. The bank then sued the sole remaining individual obligor on the mortgage note for a deficiency. In finding that a fair market value credit could apply, the court concluded that there is nothing in the statute which "precludes a court from applying equitable principles to impose a fair market value credit to prevent a windfall or where circumstances require equitable relief in the interests of justice." The court also took notice of the equities where "the security value being in excess of the debt was derived not from the debtor, but from the creditor." Thus, the court remanded the case for a deficiency hearing to determine the fair market value of the property at the time of the foreclosure sale.

Likewise, in Resolution Trust Corporation v. Berman Industries, 271 N.J. Super. 56 (Law Div. 1993), the trial court found that even a guarantor, as opposed to the principal obligor in Citibank, was entitled to a fair market value hearing on equitable grounds where the lender purchased a property for a nominal amount prior to suing the guarantor on the note. The court specifically rejected the lender's attempt to distinguish Citibank based on the primary obligor versus guarantor status of the defendant. The court found this to be "a distinction without a difference." Thus, after the Resolution Trust case, it appeared clear that a debtor in New Jersey, whether the principal obligor or a guarantor, was entitled to a fair market value hearing and credit based on equitable grounds.

Then, perhaps as a result of an improving economy or a partial change in the members of the appellate panel from that in Citibank, the Appellate Division in Summit Trust v. Willow Business Park, 269 N.J. Super. 439 (App. Div.), certif. denied, 136 N.J. 30 (1994), remarkably found that where a commercial lender sued on the mortgage note prior to foreclosure, it had no duty to give the obligor a fair market value credit. In analyzing the prior cases, the court in Summit Trust found that none of those cases stood for the proposition that the lender on a commercial loan secured by a mortgage and personal guarantees must provide the guarantors with the property's fair market value in a proceeding on the guaranty, thereby looking primarily to the property to secure a payment. Interestingly, the Summit Trust court indicated that it was the debtor who had the choice to make. The debtor could choose to sell the property to pay off their debt, thereby not subjecting their personal assets beyond what might be obtained from the sale of the property, or if they choose not to sell, and their personal assets were insufficient and the bank later chose to foreclose, the debtors at that later time may assert a right to a fair market value credit.

What the court does not address in Summit Trust is the impact of either being required to pay the full judgment if the debtor's assets are sufficient or being subject to execution under a judgment for the full amount where the bank has determined that it will not soon foreclose. It would appear that the distinction made by the Summit Trust court between a primary obligor and a guarantor does not rest on any strong equitable or legal grounds. Rather, the court noted that "it was the defendants, not the bank, who wanted to purchase and develop the property" and nothing in the prior case law should "warrant saddling the bank with the property as its primary source of security."

Some commentators on this subject have noted that the primary difference between the results in Citibank and Resolution Trust on the one hand, and Summit Trust on the other, may be the timing of the foreclosure action in relation to the deficiency action. In the earlier cases that held that a credit should apply, the foreclosure action occurred before or contemporaneous with the deficiency action, whereas in Summit Trust, the deficiency action against the guarantor occurred before any foreclosure action. Thus, it would appear that a lender would be best served filing an action against a debtor, particularly a guarantor with assets, prior to foreclosing on the commercial real estate. Perhaps even more significant to a future appellate panel may be the existence of a lender appraisal that indicates a fair market value in excess of the alleged deficiency amount. Finally, the greatest influence on a future court considering the application of the non-statutory fair market value credit may be the state of the economy and its impact on the commercial real estate market.

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