

Enforceability of Non-recourse Carve-out Upheld by New Jersey Appellate Division

Lydia C. Stefanowicz

January 2010

In a case of first impression in the State of New Jersey, the Appellate Division of the Superior Court upheld the enforceability of a carve-out in a non-recourse mortgage note that triggered full personal liability for a deficiency on the part of the borrower and guarantors. *CSFB 2001-CP-4 Princeton Park Corporate Center, LLC v. SB Rental I, LLC, et al.*, 410 N.J. Super. 114, 980 A.2d 1 (App. Div. 2009)

The *Princeton Park* case is particularly noteworthy because of the fact that the breach triggering recourse liability had been cured some eighteen months prior to payment default and there was no evidence that the lender had been damaged by the breach.

On May 2, 2001, Credit Suisse First Boston Mortgage Capital, LLC (together with its successors, "Lender") made a \$13,300,000 mortgage loan ("Loan") to SB Rental I, LLC ("Borrower"). The Loan was evidenced by a note and secured by a first mortgage lien on commercial property in South Brunswick, New Jersey ("Mortgaged Property"). The Loan was also guaranteed by Borrower's principals ("Guarantors").

The Loan was non-recourse, precluding Lender from seeking recovery against Borrower or Guarantors in the event of a default. The non-recourse provisions of the mortgage note did, however, contain carve-outs, including one that provided that the debt would become fully recourse if Borrower obtained subordinate financing encumbering the Mortgaged Property with Lender's prior written consent. The guaranty held the Guarantors liable to the same extent as Borrower under the loan documents.

Three years after the Loan closed, Borrower obtained a \$400,000 subordinate loan and granted a second mortgage on the Mortgaged Property in favor of the subordinate lender without obtaining Lender's prior written consent. This clearly triggered the full recourse liability of

Attorneys

Lydia C. Stefanowicz

Published Articles (Cont.)

Borrower and Guarantors. However, the subordinate loan was satisfied in full seven months later in December 2004, although the subordinate lender neglected to timely discharge its mortgage of record.

Eighteen months later, Borrower stopped making its monthly mortgage payments to Lender, presumably as a result of the loss of the sole tenant on the Mortgaged Property. Shortly thereafter Lender instituted a foreclosure action, and obtained summary judgment in March of 2007. The Mortgaged Property was sold at sheriff's sale. Lender then filed suit against Borrower and Guarantors ("Defendants") seeking recovery of the deficiency on the mortgage note. In that action, Lender moved for summary judgment, seeking full recourse liability against Defendants on the basis of the default arising from the subordinate financing. Defendants argued that since Lender was not harmed by the subordinate lien on the Mortgage Property, the non-recourse carve-out clause in unenforceable as a penalty provision. The lower court disagreed. Concluding that the non-recourse carve-out provision addresses liability rather than damages, the lower court emphasized the business sophistication of Defendants: "These are sophisticated defendants that were dealing at arms length when they signed the absolute and unconditional guarantee to govern the instances in which recourse liability would be triggered. The parties understood the provisions, and how they would operate, when they entered into the agreement, as they bargained for the opportunity to avoid recourse liability in certain instances, yet engaged in conduct that they knew would implicate personal liability if discovered."

On appeal by the Defendants, the Appellate Division agreed with the lower court, noting that when the terms of a contract are clear, the court should enforce it as written and "not make a better contract for either of the parties." Furthermore, the Appellate Division refused to accept the Defendants' argument that since the breach that triggered personal liability was cured and resulted in no harm to Lender, enforcement of the carve-out provision is unfair and unjust. Instead the *Princeton Park* court cited a number of out-of-state cases for the proposition that courts have uniformly held non-recourse carve-out provisions to be valid and enforceable.

Two of the cases cited by the *Princeton Park* court involved non-recourse carve-outs triggered by a borrower's bankruptcy after foreclosure was commenced. Thus, in these cases, the lender was impeded or delayed in the exercise of its remedies. In one such case the bankruptcy was eventually dismissed, but not within the 90-day grace period provided by the carve-out provision in question. *See Nationwide Bank v. Brookhaven Realty Assocs.*, 233 A.D. 2d 618, 637 N.Y.S. 2d 418 (N.Y. App. Div.), appeal dismissed, 88 N.Y. 2d 936, 647 N.Y.S. 2d 715, 670 N.E. 2d 1347 1996); *FDIC v. Prince George Corp.*, 58 F. 3d 1041 (4th Cir. 1995). Another case relied upon by the Appellate Division involved borrower's misappropriation of \$2 million received in settlement of a zoning board appeal relating to the mortgaged property, which settlement funds themselves constituted part of the mortgaged property. *Blue Hills Office Park LLC v. J.P. Morgan Chase Bank*, 477 F.Supp. 2d 366 (D. Mass. 2007). From the facts as stated, the triggering event in each of these cases cited resulted in some damage or harm to the lender. That was not true of the triggering event in *Princeton Park*, which was fully cured long before the occurrence of the default that led to the foreclosure and long before Lender exercised its remedies. The Appellate Division gave those distinctions no weight, saying: "[T]he fact that the subordinate financing was paid off well before the defendants'

Published Articles (Cont.)

ultimate default on payment of the principal loan does not alter the fact that defendants breached the very obligation identified by both parties as posing a special risk to plaintiff.... By further encumbering the property, even if only temporarily, defendants' action had the potential to affect the viability and value of the collateral that secured the original loan. Indeed it cannot be said with any certainty that the subordinate financing in this case was entirely unrelated to the defendants' ultimate default on their mortgage payments. In any event, the fact that such potential may not have actualized does not diminish the breach of obligation nor vitiate its contracted-for-consequences. Having freely and knowingly negotiated for the benefit of avoiding recourse liability generally, and agreeing to the burden of full recourse liability in certain specified circumstances, defendants may not now escape the consequences of their bargain."

The message to non-recourse commercial mortgage borrowers in New Jersey is clear. The plain literal terms of non-recourse carve-out provisions will be enforced strictly regardless of whether the triggering breach has been cured or whether the lender has suffered actual harm or damage as a result of the triggering event.