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CLIENT ALERT

"NEW JERSEY ENFORCES FULL RECOURSE CARVE-OUT"

Date: August 12, 2009

Issue: Enforceability of a non-recourse carve-out provision in Note and Guaranty

On August 11, 2009, the Appellate Division of the Superior Court of New Jersey upheld the enforceability of a non-recourse carve-out provision pertaining to the encumbrance of commercial property by a second mortgage without the lender's prior written consent. *CSFB 2001-CP-4 Princeton Park Corporate Center, LLC v. SB Rental I, LLC*, Docket No. A-6307-07T2 (NJ App. Div. 2009). It is important to note that the carve-out provision enforced by the court rendered the Loan **fully recourse** to the Borrower and Guarantors and was not merely a claim, damage or loss carve-out.

FACTS:

On May 2, 2001, Credit Suisse First Boston Mortgage Capital, LLC granted a mortgage loan to SB Rental I, LLC in the original principal amount of \$13,300,000.00 (the "**Loan**"). The Loan was evidenced by a note (the "**Note**") and secured by a first mortgage encumbering commercial property located in South Brunswick, NJ (the "**Property**"). The Loan was also secured by a guaranty of payment (the "**Guaranty**") executed by three individuals (the "**Guarantors**"). The Loan was a non-recourse loan subject to non-recourse carve-out provisions contained in the Note and Guaranty. The Note contained the following carve-out provision:

Notwithstanding anything to the contrary in this Note or any of the Loan Documents . . . (B) the Debt shall be fully recourse to Maker in the event that . . . (iii) Maker fails to obtain Payee's prior written consent to any subordinate financing or other voluntary lien encumbering the Mortgaged Property (*Emphasis added*)

The Guaranty contained the following carve-out provision:

Notwithstanding anything to the contrary in any of the Loan Documents . . . (ii) Guarantor shall be liable for the full amount of the Debt in the event that . . . (C)

Borrower fails to obtain Lender's prior written consent to any subordinate financing or other voluntary lien encumbering the Mortgaged Property (*Emphasis added*)

During the term of the Loan, Borrower obtained, without the consent of the Lender, a \$400,000.00 mortgage loan from L.G. Financial Consultants, Inc. and secured such Loan with a second mortgage on the Property (the "**Second Mortgage Loan**"). In doing so, Borrower triggered the non-recourse carve-out provision in the Note and Guaranty rendering the Loan fully recourse to Borrower and Guarantors.

The Second Mortgage Loan was fully satisfied in December of 2004, seven (7) months after it was obtained. However, a discharge of the second mortgage was not timely recorded.

In May of 2006, Borrower failed to make its monthly loan payment for the Loan because of the loss of its sole tenant, and didn't make any subsequent principal or interest payments. The Lender instituted a foreclosure action, which Borrower did not contest, and the Lender obtained a foreclosure judgment on March 28, 2007. The Property was then sold at a Sheriff's Sale.

Thereafter, the Lender instituted a deficiency action against Borrower and Guarantors for the balance of the Loan. Lender moved for summary judgment, seeking full recourse liability against Borrower and Guarantors based on the Second Mortgage Loan being obtained without the consent of the Lender. Borrower and Guarantor opposed the summary judgment motion arguing that the Lender was not harmed by the Second Mortgage Loan and therefore the carve-out provision was an unenforceable penalty.

COURT HOLDINGS:

The lower court judge ruled in favor of the Lender. The court found that the damages sought by Lender were not speculative nor estimated, but actual and fair, and that the carve-out provision addresses liability rather than damages. As a result, a judgment in the amount of \$5,195,932.72 was entered against Borrower and Guarantors.

The Appellate Division affirmed the lower court's decision. The appellate court concluded that the non-recourse provision was clearly written and negotiated between sophisticated parties. Further, the court concluded that the carve-out clause is not a liquidated damages provision because the clause operates to define personal liability and not affix probable damages, and it provides for only actual damages. The actual damages being the amount remaining on the Loan. Further, the court determined that it was not relevant that Borrower cured the breach that triggered Borrower and Guarantors' personal liability under the Note and Guaranty (i.e. full repayment of the Second Mortgage Loan) because this was their bargained for provision. Also it was not relevant that the Lender did not suffer any damages. The court cited with approval the following line of cases. *Blue Hills Office Park LLC v. J.P. Morgan Chase Bank*, 477 F. Supp. 2d 366, 377-383 (D. Mass. 2007)(transfer of mortgaged property without lender's consent and various other conduct rendered the borrower and guarantors fully liable for a loan deficiency); *First Nationwide*

Bank v. Brookhaven Realty Assocs., 223 A.D.2d 618, 637 N.Y.S.2d 418 (N.Y. App. Div.), appeal dismissed, 88 N.Y.2d 963, 647 N.Y.S.2d 715, 670 N.E.2d 1347 (1996)(bankruptcy filing not dismissed within 90 days of filing triggered recourse liability under a loan carve-out provision); and *FDIC v. Prince George Corp.*, 58 F.3d 1041, 1045-1050 (4th Cir. 1995)(recourse liability affirmed where the borrower filed a bankruptcy petition in violation of a carve-out provision).

FUTURE ACTION:

Because of the parties involved and the importance of the decision, we would not be surprised if an appeal was filed with the NJ Supreme Court.